Taxpayer Bill of Rights 3
and
Tax Simplification Proposals

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UNIFORM "REASONABLE CAUSE" EXCEPTION FOR PENALTIES

Current Law

Many penalty provisions in the Code do not apply if the taxpayer had "reasonable cause" for he transgression -- for example, section 6651(a)(1) (failure to file penalty); sections 6651(a)(2) and (a)(3) (failure to pay penalties); sections 6652(a)-(f), (h)-(i), and (l) (information return penalties); section 6656 (failure to make deposits); and section 6657 (bad checks). Section 6664(c) also generally provides that no "accuracy related penalty" shall apply if there was "reasonable cause" and the taxpayer "acted in good faith." Certain other penalties regarding statutory filing or payment requirements are imposed on a strict liability basis. For example, there is no "reasonable cause" exception for the penalties under the following provisions:

- sections 6654 and 6655, for failures to pay estimated taxes (although there is a $500 threshold before the penalty applies, and the Secretary may waive the penalty if it is determined that "by reason of casualty, disaster, or other unusual circumstance" its imposition "would be against equity and good conscience");
- section 6652(g), for failure to make a report under section 219(f)(4) (relating to voluntary contributions to a retirement savings plan);
- section 6652(k), for failure to make a report as to certain small business stock under section 1202; and
- section 6683, for foreign corporations that fail to report personal holding company income.

Reasons for Change

Generally, taxpayers who have "reasonable cause" for failing to meet a statutory requirement should not be subject to a penalty. Moreover, the Tax Code's penalty structure is complicated by the multiplicity of exceptions. A single, uniformly applicable standard for determining whether a taxpayer had "reasonable cause" will simplify the Code's penalty structure. Finally, failures to comply with statutory filing or payment requirements should be treated alike for penalty purposes. A single "reasonable cause" exception will ensure that failures to meet such statutory requirements are treated uniformly.

Proposal

The proposal would provide a uniform "reasonable cause" exception for all penalties that relate to failure to file a return, information statement, or similar document, or failure to pay or deposit required taxes. The proposal would be effective upon date of enactment.

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

Current Law

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

Reasons for Change

In response to a Congressional mandate in the Taxpayer Bill of Rights 2 legislation, Treasury has completed a study of interest netting issues, concluding that the IRS has not performed "global" netting for two reasons. First, there is no clear authority to credit an overpayment against any tax debt other than one that is still outstanding when the credit arises, nor to refund excess underpayment interest in global situations. Second, very complex interest netting computations across tax periods are done by hand, and they cannot be automated within the IRS's current systems capabilities.

Congress has previously indicated its preference for the maximum amount of interest netting that is administratively feasible. Accordingly, this proposal will permit global interest netting in certain situations by providing clear authority for it. Further, by placing the burden on taxpayers to identify and establish appropriate global netting situations, it will provide this benefit to taxpayers in an administrable way.

Proposal

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

AMEND LIMITATIONS PERIOD FOR REFUNDS IN TAX COURT

Current Law

The Code contains a fairly complex system of limitations on tax refunds. Section 6511 of the Code provides both a limitation on the time period in which a claim for refund can be made (section 6511(a)) and a limitation on the amount that can be allowed as a refund (section 6511(b)). Section 6511(a) provides the general rule that a claim for refund must be filed within 3 years of the date of the return or 2 years of the date of payment of the taxes at issue, whichever is later. Section 6511(b) limits the refund amount that can be recovered: if a return was filed, a taxpayer can recover amounts paid within 3 years before the claim, and if no return was filed, a taxpayer can recover amounts paid within 2 years before the claim. Section 6512(b)(3) incorporates these rules where taxpayers who challenge deficiency notices in Tax Court are found to be entitled to refunds.

In Commissioner v. Lundy, 116 S. Ct. 647 (1996), the taxpayer had not filed a return, but received a notice of deficiency within 3 years after the date the return was due and challenged the proposed deficiency in Tax Court. The Supreme Court held that the taxpayer could not recover overpayments attributable to withholding during the tax year, because no return was filed and the 2-year "look back" rule applied. Since overwithheld amounts are deemed paid as of the date the taxpayer's return was first due (i.e., more than 2 years before the notice of deficiency was issued), such overpayments could not be recovered. By contrast, if the same taxpayer had filed a return on the date the notice of deficiency was issued, and then claimed a refund, the 3-year "look back" rule would apply, and the taxpayer could have obtained a refund of the overwithheld amounts.

Reasons for Change

The rule at issue in Lundy is a technical trap for the unwary that is arguably inconsistent with both the general goal of the statutory scheme and commonly held taxpayer beliefs. In general, taxpayers should have at least 3 years from the due date of a return in order to claim a refund, and the 2-year "look back" rule should apply only with respect to refund claims filed after the initial 3-year period has expired. A taxpayer who fails to file a return and then receives a notice of deficiency (as in Lundy) should be treated the same as a taxpayer who files a late return/refund claim on the same date that the notice of deficiency is issued. Taxpayers in both situations should get the benefit of the 3-year "look back" rule.

Proposal

The proposal would permit taxpayers who initially fail to file a return, but who receive a notice of deficiency and file suit to contest it in Tax Court during the third year after the return due date, to obtain a refund of excessive amounts paid within the 3-year period prior to the date of the deficiency notice. The proposal would apply to claims for refund with respect to tax years ending after the date of enactment.

REPEAL AUTHORITY TO DISCLOSE WHETHER A PROSPECTIVE JUROR HAS BEEN AUDITED

Current Law

In connection with a civil or criminal tax proceeding to which the United States is a party, section 6103(h)(5) permits the IRS to disclose, either to the Justice Department or to another party to the proceeding, the fact of whether a prospective juror has ever been subject to an IRS audit or other investigation.

Reasons for Change

The general privacy policy behind section 6103 is that taxpayer information should remain confidential, and that exceptions to the confidentiality requirement should only be available where tax information is needed for other important public policy reasons. The section 6105(h)(5) disclosure requirement, however, involves a disclosure of potential jurors' confidential tax information that is of little utility either to the Justice Department or to individual parties. It has also caused unnecessary delays and confusion in both civil and criminal tax litigation.

Proposal

Section 6103(h)(5) would be repealed. There would no longer be any authority for the IRS to disclose whether any juror had been subject to an IRS audit or investigation. The provision would be effective with respect to judicial proceedings commenced after the date of enactment.

CLARIFY STATUTE OF LIMITATIONS FOR PASS-THROUGH ENTITIES

Current Law

Pass-through 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' partners (or shareholders or beneficial owners) report their pro rata share of the taxable income items (income, deduction, gain, loss, and credit) and are liable for any taxes due.

There has been some ambiguity whether the 3-year statute of limitations for assessments against partners (or shareholders or beneficial owners) of pass-through entities runs from the filing date for the entity's information return or from the filing date for the return of the partner, shareholder, or beneficial owner. In 1993, the Supreme Court held in Bufferd v. Commissioner, 113 S.Ct. 927 (1993), that the limitations period for assessing the income tax liability of an S corporation shareholder runs from the date that the shareholder's return is filed.

Reasons for Change

One purpose of limitations periods is to permit taxpayers and the IRS to reach final closure with respect to past tax liabilities. For pass-through entities other than S corporations, however, the appropriate statute of limitations is somewhat uncertain. This proposal will provide greater certainty for taxpayers, the IRS, and the courts with respect to taxpayers' liabilities.

Proposal

The proposal would clarify that the return that starts the statute of limitations for a partner (or shareholder or beneficial owner) of a pass-through entity is the return of the partner (or shareholder or beneficial owner), and not the return of the entity from which the taxpayer has received an item of income, deduction, gain, loss, or credit.

CLARIFY PROCEDURES FOR ADMINISTRATIVE COST AWARDS

Current Law

Under section 7430 of the Code, 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.

However, the procedures applicable to such requests are somewhat unclear. No time period is specified within which the taxpayer must apply to the IRS for an award of administrative costs. In addition, no time period is specified for a taxpayer to appeal to the Tax Court under section 7430(f) an IRS decision denying an award of administrative costs. Finally, the appealability of a Tax Court order denying administrative and costs is also uncertain.

Reasons for Change

The procedures applicable when taxpayers are seeking administrative costs should be clear and simple. Clarifying these matters will provide certainty to taxpayers, the IRS, and the courts, and will also ensure that these issues are resolved in a timely manner and without undue delay.

Proposal

The proposal would provide that a taxpayer must apply for the costs of an administrative proceeding before the IRS within 90 days after the date on which the final decision of the IRS as to the determination of tax, interest, and penalties is mailed to the taxpayer. It would further provide that under section 7430(f) the taxpayer must petition the Tax Court within 90 days after the IRS mails the taxpayer by certified or registered mail a notice denying the application for costs. Finally, it would provide that Tax Court orders disposing of applications for administrative costs are appealable in the same manner as other decisions of the Tax Court. The proposal would be effective with respect to costs incurred in civil actions or proceedings commenced after the date of enactment.

EQUITABLE TOLLING

Current Law

Section 6511 of the Internal Revenue Code sets forth the limitations periods for claiming refunds of federal taxes. The general rule is that a refund claim is timely if it is made within 3 years of the date of filing the return or 2 years of the date of payment, whichever is later. A refund claim that is not filed within these specified time periods is rejected as untimely. The Supreme Court recently held in the United States v. Brockamp, 117 S.Ct. 849 (1997), that these periods of limitations could not be extended, or "tolled," for equitable reasons.

Reasons for Change

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

Proposal

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

CLARIFY PROHIBITION ON "BROWSING" OF RETURNS AND RETURN INFORMATION

Current Law

Section 6103 of the Internal Revenue Code sets forth a general rule that returns and return information are confidential and cannot be disclosed for any reason. It enumerates specific circumstances under which disclosure is expressly authorized. Section 7213 of the Code serves as an enforcement mechanism for the confidentiality rules, providing criminal penalties for the willful unauthorized disclosure of returns and return information. Federal employees may also be penalized by dismissal from employment. It is also a separate Federal crime to intentionally access a computer and thereby obtain information from any department or agency of the United States. 18 U.S.C. § 1030(a)(2)(B).

Section 7431 of the Code provides that a taxpayer whose tax information is knowingly or by reason of negligence disclosed in violation of section 6103 may bring a civil action for damages against the United States (if the person responsible for the disclosure is a Federal officer or employee) or against the person responsible for the disclosure (if such person is not a Federal employee). The taxpayer can recover the greater of $1,000, or the sum of actual damages, punitive damages (only allowable in cases of willful disclosure or gross negligence) and costs. No liability is imposed where the disclosure is a result of a good faith, but erroneous, interpretation of section 6103.

Reasons for Change

The legislative history of section 6103 indicates that the term "disclosure" includes "inspection." However, there is a question whether merely inspecting returns or return information (e.g., "browsing"), without disclosing them to any other person, is prohibited in all circumstances, for example unauthorized inspection of tax documents. Although the IRS expressly prohibits employees from "browsing," and accessing a computer to obtain tax information is already a crime, some IRS employees have nonetheless engaged in such activities. Willful unauthorized inspections of returns or return information should be subject to separate criminal penalties. Further, it is appropriate for taxpayers whose tax information has been improperly inspected to have the same civil remedies as taxpayers whose information has been unlawfully disclosed.

Proposal

The proposal would clarify that, even without a further disclosure, unauthorized inspection of returns and return information is punishable as a separate criminal offense under the Internal Revenue Code. The proposal would apply to officers and employees of the United States, any contractor, and certain other designated recipients of returns and return information. The penalty upon conviction would be a fine of up to $1,000, or imprisonment for up to one year, or both. Federal officers and employees would also be subject to dismissal from employment.

The proposal would also provide that taxpayers whose tax information has been unlawfully inspected could bring a civil action under section 7431. Finally, the proposal would require notification to the taxpayers whose tax information has been improperly inspected or disclosed whenever a person is indicted or otherwise charged with a violation of the existing criminal provisions applicable to computer access or disclosures, or a violation of the new criminal provision.

The proposal would apply to violations occurring on and after the date of enactment.

INCREASE STANDARD DEDUCTION ATTRIBUTABLE TO DEPENDENT UNEARNED INCOME

Current Law

The standard deduction for a taxpayer who is a dependent of another taxpayer is the greater of a fixed amount (estimated to be $700 in 1998) or the individual's earned income, but not more than the regular standard deduction (estimated to be $4,250 in 1998 for a single taxpayer).

For dependents under age 14, unearned income less than twice the fixed amount is taxed at 15% (to the extent not otherwise offset by the standard deduction), and the excess is taxed at the higher of the parents' or the dependent's tax rate. In addition, in determining the alternative minimum tax (AMT) of these dependents, special rules apply which depend on the AMT profile of the dependent's parents and siblings. For example, a dependent's AMT may not exceed the dependent's share of the increased AMT of his parent that would be attributable to the inclusion of the income of the dependent and his siblings in computing the parent's AMT.

Reasons for Change

Changing the formula for the standard deduction of dependent filers to the individual's earned income plus a fixed amount (rather than the greater of the two) would reduce the number of tax returns required to be filed by dependent filers whose total income exceeds the fixed amount. The proposal would allow children (who have unearned income) to earn a greater amount of income without being subject to tax and would thereby encourage them to work and save for their education or other needs.

In addition, the current law's requirement that certain dependents must refer to the AMT profile of parents and siblings in determining their own AMT is unduly complex. The proposal would eliminate this complexity.

Proposal

The standard deduction for dependents would be increased to the individual's earned income plus $700 (indexed after 1998) up to the regular standard deduction. In addition, all ties between a child's AMT returns and the AMT returns of his parents and siblings would be eliminated.

The proposal would be effective for taxable years beginning after December 31, 1997.

SIMPLIFICATION OF CHILD DEPENDENCY EXEMPTION RULES

Current Law

A taxpayer may claim another individual as a dependent if the following five tests are met: (i) the dependent is within a specified relationship with the taxpayer (e.g., a child) or is any other individual who has resided with the taxpayer a full year; (ii) the dependent's gross income is less than the exemption amount, except that children are exempted from this test if they are under the age of 19 (or 24 if a full-time student); (iii) the taxpayer provides over half of the dependent's total support; (iv) the dependent does not file a joint return; and (v) the dependent is either a U.S. citizen or a resident of the U.S., Canada, or Mexico. For purposes of determining whether a taxpayer provides over half of an individual's support, public assistance payments are taken into account as support payments made by a governmental authority.

In the event of divorce or separation, the custodial parent is generally entitled to the dependent exemption if both parents provide over half the support of the child. To qualify as the custodial parent, the taxpayer must reside with his or her child for over half the year. The custodial parent may waive the exemption to the noncustodial parent by providing the noncustodial parent with a written waiver.

For dependency exemption purposes, a foster child is defined as an individual who is a child who is in the care of a person or persons (other than the parents or adopted parents of the child) who care for the child as their own child. Status as a foster child is not dependent upon the circumstances under which the child became a member of the household. A foster child must reside with the taxpayer for the full tax year.

For purposes of the earned income tax credit (EITC), a child is a qualifying child if the following three requirements are met: (i) the child must be the son, daughter, grandchild, or foster child of the taxpayer; (ii) the child must generally reside with the taxpayer in the U.S. for over half the year (or a full year in the case of a foster child); and (iii) the child must be under the age of 19 (or 24 if a full-time student). In addition, if more than one taxpayer satisfies the age, relationship, and residence tests with respect to the same child, only the taxpayer with the highest adjusted gross income can claim the child.

Reasons for Change

The proposal would simplify tax filing requirements for many taxpayers who reside with either their children or grandchildren. Many taxpayers would no longer be required to maintain extensive records (other than proof of residency) to prove that they support their own children.

In addition, the proposal would allow some public assistance recipients to claim dependent exemptions for their children. Allowing public assistance recipients to claim their children as dependents may reduce or eliminate their income tax liability on earned income.

The proposal would also more closely conform the rules for dependent children to those used for EITC qualifying children and may, as a consequence, further reduce taxpayer confusion. Under current law, a child may qualify a custodial parent for the EITC but not the dependent exemption. Under the proposal, taxpayers would be able to claim the same child for dependency exemption and EITC purposes.

The proposal would also clarify the definition of foster children. Current law does not provide the taxpayer or the IRS with sufficient guidance as to the application of the rule that "the taxpayer must care for the child as if the child were his or her own." By specifying that a foster child must meet either a relationship or legal status test, the proposal eliminates much of the ambiguity in current law.

Proposal

Under the proposal, taxpayers would no longer have to meet the support test in order to claim a child as a dependent if the child meets the following three requirements: (i) the child is the son, daughter, stepchild, grandchild or foster child of the taxpayer; (ii) the child is under the age of 19 at the end of the taxable year (24 in the case of a full-time student); and (iii) the child lives with the taxpayer for over half the year (a full year in the case of foster children). If more than one taxpayer could claim the child as a dependent under the proposed rule, the taxpayer with the highest adjusted gross income would be entitled to the dependency exemption.

The proposal would eliminate the current law requirement that a custodial parent is entitled to the dependent exemption only if both parents provide over half the support of the child. Thus, under the proposal, a custodial parent would be entitled to the dependent exemption if the proposed rule's requirements were met. The custodial parent's right to waive the exemption to the noncustodial parent by providing the noncustodial parent with a written waiver would not be changed.

The proposal would also provide that a custodial taxpayer who is not required to meet the support test under the proposal may waive the exemption to another taxpayer if the noncustodial taxpayer provides over half of the dependent's total support and meets the other current law rules for dependency (e.g., the relationship or residency tests under the broader dependency tests).

Also, for purposes of the dependency exemption residency and gross income tests, a foster child would be defined as a child who is (1) under the age of 19 (24 if a full-time student), (2) cared for by the taxpayer as if he or she were the taxpayer's own child, and (3) either the taxpayer's niece, nephew, or sibling, or had been placed in the taxpayer's home by an agency of a state or one of its political subdivisions or a tax-exempt child placement agency licensed by a state. In addition, under the proposal, grandchildren would be exempted from the gross income test if they are under the age of 19 (or 24 if a full time student).

The proposal would be effective for taxable years beginning after December 31, 1997.

ELIMINATION OF HOUSEHOLD MAINTENANCE TEST FOR CHILD AND DEPENDENT CARE TAX CREDIT

Current Law

A taxpayer who incurs expenses for the care of a qualifying individual in order to work is eligible for a nonrefundable tax credit. A qualifying individual is (i) a dependent of the taxpayer who is under the age of 13; (ii) a dependent of the taxpayer who is physically or mentally incapable of taking care of himself or herself; or (iii) the spouse of the taxpayer if the spouse is physically or mentally incapable of taking care of himself or herself. A taxpayer must provide over half the costs of maintaining the household in which the taxpayer and the qualifying dependent reside.

In order to qualify for the child and dependent care credit, single and married taxpayers must provide over half the costs of maintaining a home in which they and their dependents reside. To qualify for the head of household filing status, single taxpayers must meet this requirement but must also demonstrate that they resided in the household for over half the year.

Reasons for Change

Requiring taxpayers to meet a unique household maintenance test for the child care credit adds complexity to the tax code. Moreover, taxpayers should not be required to maintain a household in order to qualify for the child and dependent care tax credit. Child care expenses are a legitimate cost of earning taxable income, and these costs can be incurred even if the taxpayer is not the head of a household.

Proposal

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

This proposal would be effective for tax years beginning after December 31, 1997.

OPTIONAL SELF-EMPLOYMENT CONTRIBUTIONS ACT (SECA) COMPUTATIONS

Current Law

The Self-Employment Contributions Act (SECA) imposes taxes on net earnings from self-employment to provide social security coverage to self-employed workers. The maximum amount of earnings subject to the self-employment (or SECA) tax is coordinated with, and is set at the same level as, the maximum level of wages and salaries subject to FICA taxes ($65,400 for OASDI taxes in 1997 and indexed annually, and without limit for the Hospital Insurance tax). Special rules allow certain self-employed individuals to continue to maintain social security coverage during a period of low income. The method applicable to farmers is slightly more favorable than the method applicable to other self-employed persons.

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

Reasons for Change

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

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

Proposal

The two current optional methods would be combined into a single combined optional method under which self-employment income for SECA tax purposes would be two-thirds of the first $2,400 of gross income. A self-employed worker could elect the proposed combined optional method an unlimited number of times. If it is used, it must be applied to all self-employment earnings for the year, both farm and nonfarm. As under current law, the $2,400 amount would not be indexed for inflation. The proposal would be effective for tax years beginning on or after January 1, 1998.

INCREASE DE MINIMIS THRESHOLD FOR ESTIMATED TAX TO $1,000

Current Law

Individuals who fail to make timely payments of estimated income tax are subject under section 6654 to a penalty equal to the underpayment interest rate times the amount of each underpaid installment of estimated tax for the period of the underpayment. The amount of the total required estimated tax is either 90% of the tax shown on the return for the current year or 100% of the tax for the preceding year (110% if the preceding year's adjusted gross income exceeds $150,000), but the penalty applies only to the amount by which each payment falls short of the required installment amount. The period for which the penalty is imposed starts with the due date for each installment and runs through the date of actual payment or the return due date, whichever is sooner. No penalty is imposed where the total tax liability for the current year, reduced by any withheld tax and estimated tax payments, is less than $500 or where there was no tax liability for the preceding year.

Reasons for Change

The rationale behind section 6654 is slightly obscured by its label as a "penalty." The underestimation of tax penalty is akin to an interest charge to compensate the Government for the time value of the money foregone during the tax year if the taxpayer has underpaid estimated tax installments, although the penalty is not deductible. The penalty provides the Government with interest on the taxpayer's late payment of any portion of a required installment, starting with the due date for the installment payment and ending when the payment is fully made, but no later than April 15. (After April 15, the regular deficiency interest rules apply.) The exempt amounts provide de minimis exceptions to this concept.

The rationale underlying the de minimis exception is that a taxpayer should not be penalized for trivial inaccuracies in computing estimated tax payments, which can be somewhat complex to calculate. The proposed increase in the de minimis amount is justified by the burden reduction for taxpayers. After adjusting for the effects of inflation, the increase only represents a modest increase in the real value of the de minimis amount since its last change in 1985.

Proposal

The proposal would increase the exempt amount from $500 to $1,000. The proposal would be effective for taxable years beginning on or after December 31, 1997.

DE MINIMIS EXCEPTION TO PASSIVE LOSS RULES

Current Law

The passive activity rules of section 469 limit the allowance of deductions from passive activities of individuals, estates, trusts, and certain corporations. In general, the rules provide that deductions from a taxpayer's passive activities are allowed only to the extent of the income from those activities. The excess deductions (the passive activity loss) may not be used to offset income from wages, portfolio investments, and active trades or businesses. Similar limitations apply to credits from passive activities. The deductions and credits that these rules disallow for a taxable year are carried forward and treated as deductions and credits from passive activities in the following taxable year.

Special rules apply to certain real estate activities. Passive activities generally include all rental activities, but natural persons (and certain estates) may deduct up to $25,000 per year for losses from certain rental real estate activities (or claim the deduction equivalent in credits from those activities). This exemption from the passive activity limitations applies only to losses and credits from activities in which the taxpayer actively participates, and the exemption is phased out for taxpayers with adjusted gross incomes between $100,000 and $150,000.

Reasons for Change

A taxpayer who has passive losses that are disallowed for a taxable year is required to allocate suspended deductions among the taxpayer's activities and retain a record of suspended deductions for use in future years. These computational and recordkeeping requirements are unduly burdensome in the case of a taxpayer that has only a small amount of passive losses.

Proposal

A de minimis exception from the passive activity limitations would be provided for natural persons (and certain estates). Under this exception, the taxpayer's losses from passive activities would be allowed for any taxable year in which the passive activity loss does not exceed $1,000. The de minimis rule would apply only to losses; credits from passive activities would remain subject to the rules of current law. In addition, for taxpayers whose passive losses exceed the $1,000 threshold, the de minimis exception would not apply, and the passive activity limitations would apply in the same manner as under current law.

The exception would apply only to natural persons and to estates during taxable years ending less than 2 years after the death of the decedent. In addition, the threshold would be reduced to $500 for a married individual filing a separate return, and the exception would not be available to married couples who live together and file separate returns.

In general, the $1,000 threshold limitation would be applied by computing the taxpayer's passive activity loss under current-law rules. Thus, suspended deductions from passive activities would be taken into account. Losses that are allowable under the rental real estate exception would also count against the $1,000 threshold because that exception applies after the computation of the passive activity loss.

A special rule would apply to items from publicly traded partnerships. Under this rule, a taxpayer's losses from a publicly traded partnership would not qualify for the de minimis exception and would not be counted against the $1,000 threshold.

The de minimis exception would apply for taxable years beginning after December 31, 1997.

CLARIFY JURISDICTION OF THE TAX COURT WITH RESPECT TO OVERPAYMENT DETERMINATIONS

Current Law

The Tax Court has jurisdiction under section 6512(b) to determine the amount of an overpayment of tax in proper cases. The overpayment amount is required to be credited or refunded to the taxpayer when the decision of the Tax Court becomes final. If the IRS fails to make credit or refund, plus applicable interest, within 120 days after the Tax Court decision has become final, then upon motion of the taxpayer the Tax Court has jurisdiction under section 6512(b)(2) to order a refund. However, it is unclear whether such an order is appealable like other orders of the Tax Court.

Under section 6402(f), no court of the United States has jurisdiction to hear any legal or equitable action brought to restrain or review a refund offset under sections 6402(c) or (d). It is unclear, however, whether the Tax Court's overpayment jurisdiction under section 6512(b) extends to the review of refund offsets under section 6402.

Reasons for Change

The ambiguities in the Tax Court's overpayment jurisdiction should be clarified to provide certainty for taxpayers, the IRS, and the courts.

Proposal

The proposal would clarify that a Tax Court order with respect to a motion to require the refund of an overpayment is appealable in the same manner as a decision of the Tax Court. It would also clarify that the Tax Court lacks jurisdiction over the merits of credits or offsets that reduce an overpayment. The proposals would be effective on the date of enactment.

CLARIFY TAX COURT JURISDICTION OVER INTEREST DETERMINATIONS

Current Law

Section 7481(c) provides that the Tax Court can redetermine the amount of interest a taxpayer owes. Section 7481(c)(3) directs taxpayers to file a "petition" for a redetermination of interest within one year of the date a Tax Court decision becomes final.

Reasons for Change

It is unclear whether section 7481(c) applies to both interest on underpayments of tax and interest on overpayments of tax. Taxpayers should not be forced to choose a different forum for relief depending on the kind of interest that is at issue. Moreover, the term "petition" ordinarily refers only to a new proceeding commenced in Tax Court, but requests for additional relief with respect to matters that have already been pending in the Tax Court are ordinarily styled as "motions." Use of the term "petition" in section 7481(c)(3) has led to some confusion on the part of taxpayers, the IRS, and the Tax Court, and this confusion should be eliminated.

Proposal

The proposal would clarify that the Tax Court's jurisdiction to redetermine the amount of interest does not depend on whether the interest is underpayment interest or overpayment interest. The proposal would also amend section 7481(c)(3) to provide that a taxpayer must file a "motion," rather than a "petition," to seek a redetermination of interest in the Tax Court. The proposal would be effective on the date of enactment.

CLARIFY NET WORTH REQUIREMENTS FOR AWARDS OF ADMINISTRATIVE OR LITIGATION COSTS

Current Law

Under section 7430 of the Code, any person who substantially prevails in an action brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty may be awarded reasonable administrative costs incurred before the IRS and reasonable litigation costs incurred in connection with any court proceeding.

A person who substantially prevails must meet certain net worth requirements in order to be eligible for an award of administrative or litigation costs. Under Code section 7430(c)(4)(A)(iii) and 28 U.S.C. section 2412(d)(2)(B), individuals can recover costs only if their "net worth" does not exceed $2 million at the start of the (administrative or legal) action. Likewise, a corporation or partnership can obtain costs only if its net worth does not exceed $7 million. The limits applicable to trusts, estates, and joint filers are not clearly set forth, however.

Reasons for Change

There is some confusion as to the correct net worth limitations that apply to trusts, estates, and joint filers under section 7430. Clarifying this rule would provide certainty to taxpayers, the IRS, and the courts.

Proposal

The proposal would provide that the net worth limitations applicable to individuals for costs under section 7430 apply to trusts and estates as well. It would also provide that joint filers are treated as one individual for purposes of the net worth requirements, except in innocent spouse situations. The provision would apply to proceedings commenced after the date of enactment.

EXCLUSION OF CAPITAL GAINS ON SALE OF PRINCIPAL RESIDENCE

Current Law

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

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

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

Reasons for Change

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

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

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

Proposal

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

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

In the case of joint filers not sharing a principal residence, an exclusion of $250,000 would be available on a qualifying disposition of the principal residence of one of the spouses. Similarly, if a taxpayer who has not used the exclusion marries someone who has used the exclusion within the prior two-year period, the proposal would permit the newly-married couple to exclude a gain on the sale of their principal residence of up to $250,000. (After the expiration of the prior two-year period, the couple would be able to exclude $500,000.)

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

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

Current Law

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

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

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

Reasons for Change

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

Proposal

The proposal would generally codify the approach taken by the Treasury regulations and make some modifications to help clarify the rules. The proposal would add three categories of ordinary assets to section 1221: (1) derivative contracts entered into by derivative dealers; (2) supplies of a type used by the taxpayer in the provision of services or the production of ordinary property; and (3) hedges. A new section 1259 would define a hedging transaction as a transaction entered into primarily to manage the risk of ordinary property held or to be held, or a liability incurred or to be incurred, and identified as a hedge of specified property. If a transaction was improperly identified as a hedging transaction, losses would retain their usual character (i.e., usually capital), but gains would remain ordinary. If a hedging transaction was not identified (and there was no reasonable basis for the failure) gains would be ordinary but losses would retain their non-hedging character. Other rationales for ordinary treatment (such as surrogacy for a non-capital asset or insurance against a business risk) generally would not be allowed, and the proposed provisions would be the exclusive means to obtain ordinary treatment. Treasury would have authority to apply these rules to related parties.

The proposal would require that the timing of income, gain, deduction, or loss from a hedging transaction must reasonably match the income, gain, deduction, or loss from the item(s) being hedged. Taxpayers could, to the extent allowed in regulations, elect this timing for identified straddles instead of being subject to the rule that defers losses on straddles to the extent of unrecognized gain in the offsetting position. The proposal would repeal the exception from the straddle rules for stock. The proposal would clarify that interest or other periodic payments on a security that includes an offsetting position in a straddle would be capitalized as a carrying cost of the straddle under section 263(g) of the Code. Further, Treasury would have regulatory authority to integrate offsetting positions in a straddle.

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

MODIFY LOOK-BACK METHOD FOR LONG-TERM CONTRACTS

Current 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 estimated total contract costs.

Because the percentage of completion method relies upon estimated, rather than actual, contract price and costs to determine gross income for any taxable year, a "look-back method" is applied in the year a contract is completed in order to compensate the taxpayer (or the Internal Revenue Service) for the acceleration (or deferral) of taxes paid over the contract term. The first step of the look-back method is to reapply the percentage of completion method using actual contract price and costs rather than estimated contract price and costs. The second step generally requires the taxpayer to recompute its tax liability for each year of the contract using gross income as reallocated under the look-back method. If there is any difference between the recomputed tax liability and the tax liability as previously determined for a year, such difference is treated as a hypothetical underpayment or overpayment of tax to which the taxpayer applies a rate of interest equal to the overpayment rate, compounded daily. The taxpayer receives (or pays) interest if the net amount of interest applicable to hypothetical overpayments exceeds (or is less than) the amount of interest applicable to hypothetical underpayments. 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 hypothetical overpayment or underpayment of tax is deemed to have arisen on the unextended due date of the taxpayer's return and to have continued until the unextended due date of the subsequent return. Because the overpayment rates are subject to adjustment for every calendar quarter, up to five different interest rates may be applied for a hypothetical overpayment or underpayment for a single taxable year.

Reasons for Change

Although the purpose of the look-back method is to compensate the taxpayer (or the Internal Revenue Service) for the hypothetical overpayment (or underpayment) of taxes with respect to long-term contracts, the costs of compliance with the requirements of this method for a particular contract may be disproportionately large when the actual gross contract price and costs for that contract do not significantly differ from the estimates (determined on both an annual and a cumulative basis). Accordingly, the look-back method should not apply when these differences are not significant. In addition, where the look-back method is applied to a long-term contract, complexity results from a combination of the use of multiple interest rates for each computation period and the daily compounding of such interest.

Proposal

A taxpayer could elect not to apply the look-back method with respect to a long-term contract if, for each prior taxable 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. In addition, a taxpayer could 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). Finally, the number of interest rates potentially applicable under the look-back method would be reduced by using the overpayment rate in effect at the beginning of the computation period (the unextended due date of the tax return) rather than the series of rates in effect during the successive quarterly periods during the computation period.

The proposal would be effective for contracts completed in taxable years ending after date of enactment.

CORPORATE ALTERNATIVE MINIMUM TAX: SIMPLIFICATION FOR SMALL FIRMS

Current Law

The computation of the corporate alternative minimum tax (AMT) is a multi-step process. To compute alternative minimum taxable income (AMTI), the corporation starts with regular taxable income before any net operating loss deduction. That amount is increased by certain tax preferences, increased or decreased by certain adjustments, and then adjusted further by 75 percent of the difference between a broader measure of income based upon earnings and profits and AMTI (before this adjustment). The resulting AMTI, reduced by a net operating loss deduction for AMT purposes and an exemption amount, is taxed at a 20 percent rate to compute the tentative minimum tax before foreign tax credit. The tentative minimum tax can be partially offset by the AMT foreign tax credit. If the resulting amount exceeds the corporation's regular tax, the excess is the AMT (which is paid in addition to the regular tax). AMT paid becomes a credit that may be used to offset regular tax in a later year, but may not be used to reduce regular tax below tentative AMT (after the foreign tax credit) for the year in which the credit is claimed.

Prior to January 1, 1996, corporations were also subject to the corporate environmental income tax (CEIT) equal to 0.12 percent of AMTI (before net operating losses and deduction for this tax) in excess of $2 million. The revenues from this tax finance the Superfund environmental program. The FY 1998 budget proposes the reinstatement of the CEIT.

Reasons for Change

The complexity of the AMT raises concerns regarding the cost of complying with the tax laws. A corporation is required to undertake a complex set of calculations solely to determine whether it is subject to the AMT and the CEIT. Many of these corporations are then excluded from the AMT (because of the $40,000 exemption) and the CEIT (because of the $2 million exemption). In addition, corporations that are regular taxpayers, but were AMT taxpayers in a prior year, are required to calculate their tentative AMT in order to determine allowable minimum tax credits and minimum tax credit carry forwards. For small corporations, the need to determine whether AMT or CEIT is owed and the limitation on the use of AMT credits can be particularly burdensome relative to the amount of revenue raised.

Proposal

A corporation that had gross receipts that averaged less than $5 million for all prior three-year periods beginning after December 31, 1994, would be excluded from the AMT and the CEIT. A corporation that is excluded from the AMT as a result of this provision would be permitted to take a minimum tax credit for AMT incurred in prior years against regular tax after allowable credits for the taxable year. The allowable tax credit for AMT incurred in prior years would be limited to 50 percent of the taxpayer's regular tax liability. The proposal would be effective for taxable years beginning after December 31, 1997.

MODIFY AND SIMPLIFY THE SECTION 1031 LIKE-KIND EXCHANGE RULES

Current Law

Under section 1031, any gain or loss realized on the exchange of property, held for productive use in a trade or business or for investment, for "like-kind" business or investment property is deferred. Exchange treatment applies only to transactions characterized as "exchanges" of like-kind property. To the extent "boot" (i.e., money or property that is not like kind to the property transferred) is received in the exchange, gain is recognized.

The exchange requirement in section 1031 distinguishes that provision from other similar deferral provisions -- typically referred to as "rollover provisions" -- which allow a taxpayer to elect to defer gain when money or other property is received in exchange for property to the extent proceeds are invested in qualifying replacement property within a prescribed period of time (e.g., sections 1033(a)(2) (involuntary conversion of property into money), 1034 (rollover of gain on the sale of a principal residence), 1043 (sale of property to comply with conflict-of-interest requirements), and 1044 (rollover of publicly traded securities gain into specialized small business investment companies)). Generally, gain is recognized under these rollover provisions only to the extent the cost of the replacement property is less than the amount realized from the disposed property.

Section 1031 does not define the term "like kind," although there are a number of statutory rules pursuant to which certain kinds of property are not treated as like kind. Long-standing Treasury regulations explain that the term refers to the nature or character of the property and not to its grade or quality. The regulations further provide that whether any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not its kind or class. Thus, an exchange of unimproved land for a building qualifies. The regulations also include special rules for determining whether certain types of tangible personal property will be treated as like kind. With respect to intangible property, the regulations state that whether two items are of a like kind depends on the nature or character of the rights involved and also the nature or character of the underlying property to which the intangible personal property relates.

In its 1979 decision in Starker v. United States, the Ninth Circuit Court of Appeals upheld like-kind exchange treatment with respect to a transaction in which some of the replacement property was acquired 5 years after the taxpayer transferred the relinquished property. In response Congress added section 1031(a)(3), which imposes certain time restrictions with respect to "deferred" exchanges (i.e., the replacement property must be identified within 45 days and generally acquired within 180 days after the relinquished property is transferred). Regulations governing deferred exchanges were proposed in 1990 and finalized in 1991. These regulations provide safe harbors that allow taxpayers to navigate around certain practical and legal problems that arise in the context of 3-party deferred exchanges. The failure to strictly adhere to the safe harbors, however, may result in an exchange being fully taxable (e.g., instead of gain recognition being limited to the amount of boot ultimately received).

Another prerequisite for deferral under section 1031 is that both the property transferred by the taxpayer and the replacement property acquired is held by the taxpayer for productive use in a trade or business or for investment. There is some question under current law whether an exchange occurring shortly after a contribution to, or a distribution from, a partnership or corporation violates this requirement.

Reasons for Change

The statute's exchange requirement raises a number of technical legal issues regarding agency, constructive receipt, and economic benefit. The safe harbors contained in the 1991 deferred exchange regulations provide certainty for taxpayers by elevating, to some degree, form over substance. However, the requirements of the safe harbors, in keeping with the exchange requirement, also impose a certain degree of complexity and additional transactional costs. Allowing rollover treatment in lieu of the exchange requirement would reduce both the complexity and transactional costs associated with these transactions.

There are two historic justifications for permitting the deferral of gain or loss on the exchange of like-kind property. First, property that is the subject of an exchange was not generally viewed as being "cashed out." Second, exchange treatment avoids valuation disputes between the IRS and taxpayers. The validity of these rationales today is highly suspect, especially in the context of deferred exchanges. The parties to a deferred exchange almost always agree to an alternative cash purchase price should suitable like-kind property not be identified. Furthermore, the properties transferred in exchanges often provide their owners with a certain degree of liquidity as security for debt. Accordingly, it is appropriate to narrow the circumstances under which realized gain may be deferred.

Finally, there is a significant amount of uncertainty with respect to certain of the prerequisites for deferral (e.g., when shortly before or after an exchange property is contributed to a partnership or corporation or is distributed by a partnership or corporation, and whether collectibles are properly viewed as personal use items or as investments, with the answer in particular cases depending on specific, and often difficult to discern, facts and circumstances).

Proposal

The proposal would make four changes to the deferred exchange rules. The first change would simplify the treatment of deferred exchanges by replacing the exchange requirement with elective rollover treatment. A taxpayer would have until the later of 180 days, or when the taxpayer's return for the year is due, to acquire replacement property. To further simplify the rules, the present-law 45-day limit on identifying replacement property would be repealed.

Second, the "like kind" standard for replacement property would be replaced with a "similar or related in service or use" standard. The major impact of this change would be to restrict eligible replacement property for certain dispositions of real property (as the replacement of unimproved real property with improved property, or vice versa, would generally not qualify for deferral).

Third, property would only be treated as similar or related in service or use if held by the taxpayer for use in business or for investment for 1 year or more, subject to exceptions in the case of death and involuntary conversions.

Fourth, dispositions of collectibles would not be eligible for deferral.

These proposals would be effective for dispositions occurring after the date of enactment, subject to a binding-contract exception.

INDEPENDENT CONTRACTOR PROPOSALS

Current Law

Most workers are classified as employees or independent contractors for Federal income tax and Federal employment tax purposes based on the traditional common-law test for determining the employer-employee relationship. This test focuses on whether, under the specific facts and circumstances of a situation, the business has the right to control not only the result of the worker's services but also the means by which the worker accomplishes that result. The IRS has derived from the case law a variety of facts that should be considered in each case. However, since 1978 the IRS generally has been prohibited from issuing regulations or revenue rulings regarding the proper classification of workers.

The classification of a worker has implications for tax and non-tax purposes. Income, Social Security and Medicare taxes on employees are collected mainly by employers through withholding. Taxes on independent contractors are collected mainly through self-assessment. Independent contractors can offset income by deductions for business expenses that generally are not as readily available to employees (except to the extent that the employee itemizes deductions and business expenses and other miscellaneous itemized deductions exceed 2 percent of adjusted gross income). Certain fringe benefits provided by a business to employees are eligible for greater tax preferences than are available to independent contractors, although independent contractors can adopt tax-qualified self-employed retirement plans that can be similar to employer-sponsored plans for employees. There are also non-tax implications of worker classification; a variety of Federal and state labor and worker protection laws cover only employees and these laws may not have classification standards that differ from the standards that apply for Federal tax purposes.

Under section 530 of the Revenue Act of 1978, the IRS is prohibited from correcting erroneous classifications of workers as independent contractors for employment tax purposes, including prospective corrections, as long as the employer has a reasonable basis for its treatment of the workers as independent contractors and treated the workers and those holding substantially similar positions as independent contractors. In addition, even where section 530 relief is not available, section 3509 of the Code limits employers' liabilities for failure to withhold income, Social Security, and Medicare taxes to 1.5 percent of the wages paid plus 20 percent of the employee's portion of the Social Security and Medicare taxes. (Higher percentages apply if the employer has not filed an information return (form 1099) for the worker.) The employer is not relieved of liability for 100 percent of the employer portion of Social Security, Medicare or FUTA (federal unemployment insurance) taxes.

Among recent administrative initiatives taken by the IRS in the worker classification area is a classification settlement program. Businesses that have misclassified their workers as independent contractors, have filed information returns, but failed to meet the other requirements for relief under section 530, can settle the matter with the IRS by reclassifying workers prospectively and paying the following limited tax assessments. If the business clearly does not meet the section 530 substantive consistency requirement or reasonable basis test, the assessment would be limited to one year of employment tax liability (as limited by section 3509). If the business has a colorable argument that it meets the consistency and reasonable basis tests, the assessment would be limited to 25 percent of one year's income tax withholding, Social Security and Medicare tax liability (as limited by section 3509), plus the FUTA tax liability for the year.

Reasons for Change

Eliminating past employment tax liability in cases where taxpayers fall just short of meeting the section 530 requirements would eliminate the risk that a business could incur substantial employment tax liability and penalties for previous years even where they had reasonable arguments that they were entitled to section 530 relief. A legislative proposal would also give courts the authority to determine whether misclassified workers should be reclassified on a prospective basis.

Expanded Tax Court jurisdiction to cover worker classification determinations for employment tax purposes would permit disputes to be resolved more quickly and at lower cost than in Federal district court. This would provide a business with increased access to an independent judicial resolution if the business believed its determination, rather than the IRS position, was correct.

The Administration's independent contractor proposals would help taxpayers to resolve disputes with the IRS in a more simple, fair, and cost-effective manner. In combination with recent administrative initiatives, the proposals would provide significant relief to small businesses from the most serious problems relating to worker classification.

Proposals

The proposal would amend the Code to provide that businesses that fail to meet the requirements of section 530 and misclassify workers as independent contractors can reclassify their workers prospectively with no employment tax liability for prior years if Form 1099s were filed for the worker and the business has a reasonable argument that it meets the section 530 substantive consistency and reasonable basis requirements. This is intended to provide relief to taxpayers who fall just short of meeting the section 530 requirements.

In addition, the proposal would enlarge U.S. Tax Court jurisdiction to cover worker classification determinations for employment tax purposes.

INDIVIDUAL FOREIGN TAX CREDIT LIMITATION

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 IRS Form 1116, designed to elicit sufficient information to perform the necessary calculations.

Reasons for Change

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). Form 1116 requires complicated calculations for these taxpayers even though all their foreign tax credits are in the same separate limitation basket. For most of these taxpayers, applicable foreign tax credit limitations exceed the amounts of taxes paid. Therefore, relieving these taxpayers from application of the full panoply of foreign tax credit rules will in many cases achieve significant reduction in the complexity of the tax law without significantly altering actual tax liabilities.

Proposal

The proposal would allow individuals with no more than $300 ($600 in the case of married persons filing jointly) of creditable foreign taxes, and no foreign source income other than passive income, to be exempt from the foreign tax credit limitation. These individuals would be permitted to claim their foreign tax credit directly on Form 1040 without being required to file Form 1116.

A person who elects the simplified foreign tax credit rules would not be allowed to claim a credit for foreign taxes unless they are shown on a payee statement such as a Form 1099 or K-1. Foreign tax credit carryovers would not be available. In determining whether the individual received any income other than passive income, the usual statutory exceptions for high-taxed income and high-withholding-tax interest would not apply.

The proposal would be effective for taxable years beginning after December 31, 1997.

SIMPLIFICATION OF CONTROLLED FOREIGN CORPORATION RULES

Current Law

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 separate 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 the 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 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.

For foreign tax credit separate limitation purposes, a controlled foreign corporation is not treated as a noncontrolled section 902 corporation with respect to any distribution out of its earnings and profits for periods during which it was a controlled foreign corporation and, except as provided in regulations, the recipient of the distribution was a U.S. shareholder in such corporation. The consequence of not being treated as a noncontrolled section 902 corporation is application of the so-called "look-through" rule. That is, dividends paid by such a controlled foreign corporation to its U.S. shareholder are characterized for separate limitation purposes by reference to the character of the underlying earnings of the controlled foreign corporation.

Reasons for Change

The rules applicable to controlled foreign corporations, especially as they pertain to dispositions of interests in controlled foreign corporations, contain gaps, inconsistencies, and uncertainties. These result in complexity, both in the law itself and in resulting taxpayer behavior. Rationalizing some of these rules can alleviate a great deal of this complexity.

Proposal

The proposal would make a number of modifications in the treatment of income derived from the disposition of stock in a controlled foreign corporation. It 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 proposal would permit the amount of gain taxed to the U.S. shareholder to be adjusted for previous income inclusions.

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 proposal would provide a proportional reduction in the taxation of the subpart F income in that year to the acquiring U.S. shareholder.

The proposal also would repeal the limitation on look-through treatment (for foreign tax credit separate limitation purposes) of dividends from controlled foreign corporations to U.S. shareholders out of earnings from periods in which the payor was a controlled foreign corporation, but the dividend recipient was not a U.S. shareholder of the controlled foreign corporation. In addition, the proposal would clarify that an exemption or reduction by treaty of the branch profits tax that would be imposed under section 884 on a controlled foreign corporation would not affect the general statutory exemption from subpart F income that applies to U.S. source effectively connected income.

The proposal would be effective generally upon the date of enactment. The clarification of the effect of treaty-related modifications at the branch profits tax on the determination of subpart F income would be effective for taxable years beginning after December 31, 1997.

EXCHANGE RATE USED IN TRANSLATING FOREIGN TAXES

Current Law

Translation of foreign taxes. 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. This rule applies equally to foreign taxes paid directly by U.S. taxpayers, which taxes 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.

Redetermination on payment of foreign taxes. For taxpayers using the accrual basis of accounting for determining creditable foreign taxes, accrued and unpaid foreign tax liabilities denominated in foreign currencies are translated into U.S. dollar amounts at the exchange rate as of the last day of the taxable year of accrual. In certain cases where a difference exists between the dollar value of accrued foreign taxes and the dollar value of those taxes when paid, a redetermination of tax liability is required on account of the adjustment in foreign taxes. Generally, such an adjustment may be attributable to one of three causes. One cause would be a refund of foreign taxes. Second, a foreign tax redetermination may be required because the amount of foreign currency units actually paid differs from the amount of foreign currency units accrued. These first two cases generally give rise to a so-called "section 905(c) regular adjustment." Third, a redetermination may arise due to fluctuations in the value of the foreign currency relative to the dollar between the date of accrual and the date of payment. This third case gives rise to a so-called "section 905(c) translation adjustment."

Reasons for Change

The significant computational and record-keeping burdens of translating foreign tax payments into U.S. dollar amounts can be relieved by the use of average exchange rates over the period of payment. In addition, in the case of accrual-method taxpayers, further simplification can be achieved by permitting taxes to be translated at the rates applicable to the year to which the taxes relate, so long as the taxes are paid within a reasonably short period after the close of that taxable year.

Proposal

The proposal would set forth two sets of operating rules for the translation of foreign taxes. The first set would establish new rules for the translation of certain accrued foreign taxes. The other set would modify the rules of present law for translating all other foreign taxes. The proposal would also modify the provisions relating to redetermination of foreign taxes.

Translation of foreign taxes. The proposal generally would permit accrual-basis taxpayers to accrue foreign taxes at the average exchange rate for the taxable year to which such taxes relate. If tax in excess of the accrued amount is actually paid, such excess amount would be translated using the exchange rate in effect as of the time of payment. This set of rules would not apply (1) to any foreign income tax paid after the date two years after the close of the taxable year to which such taxes relate, (2) with respect to taxes of an accrual-basis taxpayer that are actually paid in a taxable year prior to the year to which they relate, or (3) tax payments that are denominated in a currency determined to be an inflationary currency.

Foreign taxes not eligible for application of the preceding rules generally would be translated into U.S. dollars using the exchange rates as of the time such taxes are paid. The IRS would be granted 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.

This part of the proposal would be effective for foreign taxes which relate to taxable years beginning after December 31, 1997.

Redetermination on payment of foreign taxes. The proposal would amend section 905(c) to require a redetermination in three cases: (1) if accrued taxes when paid (in foreign currency) differ from the amounts claimed (in foreign currency) as credits by the taxpayer, (2) if accrued taxes are not paid before the date two years after the close of the taxable year to which taxes relate, and (3) if any tax paid is refunded in whole or in part. Thus, for example, if at the close of the second taxable year after the close of the taxable year to which an accrued tax relates, any portion of the tax so accrued has not yet been paid, a redetermination under section 905(c) would be required for the amount representing the unpaid portion of that accrued tax. That is, the accrual of any tax that is unpaid as of that date would be retroactively denied. In the case of a taxpayer claiming a direct credit, any such taxes if subsequently paid would be taken into account in the year to which they relate, but translated into U.S. dollars using the exchange rates as of the time such taxes are paid. In the case of a taxpayer claiming an indirect credit, any such taxes if subsequently paid would be taken into account for the taxable year in which paid, and translated into U.S. dollars using the exchange rates as of the time such taxes are paid. The IRS would be granted authority to issue regulations that would prescribe appropriate adjustments to the foreign tax credit pools to implement or substitute for the redetermination of U.S. tax liability.

This part of the proposal would apply to foreign taxes paid or accrued after December 31, 1997.

ELECTION TO USE SIMPLIFIED FOREIGN TAX CREDIT UNDER THE AMT

Current 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 Change

The process of allocating and apportioning deductions for purposes of calculating the regular and AMT foreign tax credit limitations can be complex. Taxpayers who 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 differences between regular taxable income and alternative minimum taxable are often relevant primarily to U.S. source income. Therefore, 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 proposal would eliminate the need to reallocate and reapportion every deduction.

Proposal

The proposal would permit 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 could be used, however, only to the extent it does not exceed entire alternative minimum taxable income.

The election would be available only in the first taxable year beginning after December 31, 1997 for which the taxpayer claims an AMT foreign tax credit.

The election would apply to all subsequent taxable years, and may be revoked only with the permission of the Secretary of the Treasury.

SIMPLIFY FORMATION AND OPERATION OF INTERNATIONAL JOINT VENTURES

I. Repeal Excise Tax on Transfers to Foreign Entities and Change Source of Deemed Royalties

Current Law

Excise Tax. A 35-percent excise tax is imposed under section 1491 on transfers of appreciated property by U.S. persons to certain foreign persons. Certain elections may be made to avoid paying the excise tax. Section 1494(c) imposes a further penalty equal to 35 percent of the gross reportable amount for a failure to report any transfer described in section 1491. This penalty applies to any unreported transfer to a foreign person, even if no excise tax is payable (e.g., because the property is not appreciated).

Deemed Royalty. Section 367(d) generally provides that U.S. persons who contribute intangible assets to related foreign corporations are treated as selling the intangibles in exchange for deemed royalty payments from sources within the United States. Section 367(d) also applies to transfers to foreign partnerships where U.S. transferors elect to apply the principles of section 367.

Reasons for Change

Excise Tax. The section 1491 excise tax was originally enacted to prevent U.S. persons from avoiding U.S. tax on accrued gains by transferring appreciated property to certain foreign entities. However, other provisions of the Code now generally prevent the avoidance of U.S. tax through transfers to foreign corporations and partnerships. The primary current effect of section 1491, therefore, is now to make taxpayers provide information to the IRS. Thus, if adequate information reporting of transfers were required (see Part II of this proposal), the excise tax provision would be largely unnecessary.

Deemed Royalty. The U.S. source treatment of the deemed section 367(d) royalty was designed to encourage a U.S. transferor to enter in an actual license agreement. Such an actual license has the advantage of identifying the intangible transferred. The reporting to be required under Part II of this proposal, however, should adequately identify intangibles transferred to foreign persons without the need for U.S. source treatment.

Proposal

Excise Tax. The proposal would repeal section 1491. Thus, transfers to foreign corporations and foreign partnerships would no longer be subject to the 35-percent excise tax or to the 35-percent information reporting penalty. However, U.S. transferors would be required to recognize gain on the transfer of appreciated assets to a foreign trust or estate. In addition, a U.S. person would not be allowed to defer gain on appreciated property transferred to any foreign person pursuant to a private annuity contract or installment sale. Also, any disposition of appreciated property by a U.S. person to a foreign corporation that is not described in section 367 would be taxable. Finally, the proposal would allow the IRS to provide rules to prevent the inappropriate deflection of gain from U.S. persons to foreign persons through transfers of appreciated property to partnerships with foreign partners.

Deemed Royalty. Deemed royalties would be treated as derived from foreign sources to the extent that an actual royalty would have been paid from foreign sources. In addition, the IRS could provide rules for ensuring consistent results when intangibles are transferred to partnerships.

Effective Date. The proposal would be effective for transfers made, or royalties deemed received, after the date of enactment.

II. Simplify and Rationalize International Joint Venture Information Reporting

Current Law

The IRS may require any foreign partnership to file a U.S. partnership return if the income tax liability of any U.S. person is determined in whole or in part by taking into account (directly or indirectly) items of such partnership. If a foreign partnership is required to file a U.S. return but does not do so, and the Tax Matters Partner resides outside the United States, or the partnership books and records are maintained outside the United States, then no loss or credit is allowed to any partner. Any U.S. person acquiring or disposing of an interest in a foreign partnership, or whose proportional interest in a foreign partnership substantially changes, is required to report such acquisition, disposition or change. As previously discussed, U.S. persons are generally required to report transfers to foreign partnerships or pay a 35-percent penalty for failure to report.

Reasons for Change

Recent developments in the area of entity classification have made it easier for taxpayers to choose the form of their business entities. It is, therefore, more important that information reporting requirements and penalties with respect to foreign partnerships and foreign corporations should be comparable. However, while current law generally contains a comprehensive regime for reporting with respect to foreign corporations with U.S. owners, there is considerable confusion regarding the reporting obligations of foreign partnerships, partly caused by the potentially broad authority given to the IRS to require such reporting. Clearer and simpler statutory rules would end this confusion and encourage greater compliance.

Requiring U.S. returns from foreign partnerships may not be appropriate, particularly where the partnerships are not U.S.-controlled, as it may be difficult for the U.S. partners to compel the filing of a U.S. return. To attempt to apply other existing requirements (for example, TERRA audit procedures) to such partnerships could also be difficult. It is necessary, however, for the IRS be able to establish the correct U.S. tax treatment of foreign partnership activities. Thus, there should be a workable system of reporting by U.S. partners in foreign partnerships, supported by adequate penalty provisions for noncompliance.

Proposal

Reporting by Foreign Partnerships. A foreign partnership that carries on a U.S. trade or business or that earns U.S. source income would be required to file a U.S. return, except as provided in regulations. If such a partnership does not file the required return, the IRS would be authorized to disallow deductions, credits and losses claimed by the foreign partnership.

Reporting of Controlled Foreign Partnerships. Any U.S. Partner in a "controlled foreign partnership" ("C.P.") would be required to file annually information required by the IRS, including a balance sheet, a profit and loss statement, and a description of related party transactions. Generally, the required information would be similar to the information that is currently required from U.S. shareholders of controlled foreign corporations and currently reported on Form 5471. A C.P. would be any foreign partnership where more than 50 percent of interests in either capital, losses or profits is directly or indirectly owned by U.S. Partners. A U.S. Partner would be a U.S. person directly or indirectly holding a 10 percent or greater interest in the foreign partnership. A penalty of $10,000 would be imposed on a U.S. partner who fails to file the required return for each annual accounting period. This penalty would be increased for continuing noncompliance. In addition, if the U.S. Partner did not file the required return after further notification, the IRS could redetermine the income tax consequences resulting from the U.S. Partner's interest in the C.P. based on available information. The proposal also would conform the reporting rules and penalties that apply to shareholders of controlled foreign corporations.

Reporting of Non-Controlled Foreign Partnerships. As under current law, any U.S. person who is a partner in a foreign partnership would be required to correctly report all items attributable to the partnership interest on the partner's U.S. income tax return. Upon request by the IRS, such a U.S. person would be required to provide information necessary to substantiate the U.S. tax treatment of these items. If such person does not, the IRS would be authorized to redetermine the income tax consequences resulting from that U.S. person's ownership of its interest in the foreign partnership.

Changes in Ownership Interests in Foreign Partnerships. As under current law, any U.S. person who acquires or disposes of an interest in a foreign partnership, or whose proportional interest in a foreign partnership substantially changes, would be required to report such change. The penalty for failure to report such changes would be $10,000 for each year, and would be further increased for continuing noncompliance. The proposal would conform the reporting rules and penalties that apply to changes of ownership in foreign corporations.

Transfers to Foreign Partnerships. Certain U.S. persons would be required to report transfers of appreciated and unappreciated property to foreign partnerships that are in the nature of a contribution (e.g., under section 721). U.S. persons would be required to report such transfers if they (or related persons) held, directly or indirectly, a 5-percent interest in a foreign partnership, or if the value of transfers to the foreign partnership exceeded $100,000 in any twelve month period. In the case of CAPS, the transfers reported on the required information statement would generally fulfill this requirement. Continued reporting may be required in respect of transfers of certain appreciated property (including as to the fair market value, basis and time of disposition of such property). The penalty for failure to report such transfers of appreciated and unappreciated property would be 10 percent of the value of the transfer. A failure to comply with the reporting requirements for transfers of appreciated property would also result in full recognition of gain to the U.S. transferor of gain in the year in which the failure occurred. The proposal also would conform the reporting requirements and penalties that apply to transfers to foreign corporations.

Transfers to Foreign Trusts. Non-gratuitous transfers to related foreign trusts (including certain grantor trusts) would be reportable on an annual basis. The penalty for failure to report such transfers would be $10,000 for each year, and could be increased for continuing noncompliance.

Effective Dates. The proposal generally would be effective for taxable years of the partnership beginning after the date of enactment. The proposal would be effective for transfers to and changes of ownership in foreign partnerships occurring after the date of enactment. Taxpayers would be permitted to apply these rules retroactively to all transfers made after August 20, 1996 (and thereby satisfy the information reporting requirements of section 1494(c)). The IRS would be authorized to provide appropriate transition rules.

III. Residence of Partnerships

Current Law

A domestic partnership is a partnership created or organized in the United States, or under the laws of the United States or of any State. A foreign partnership is any partnership that is not a domestic partnership.

Reasons for Change

For U.S. tax purposes, business activities between persons may create partnerships without formal agreements. It is often difficult to determine whether such a "tax partnership" is "created or organized" in the United States. Difficult issues may also arise when attempting to apply the "created or organized" test to foreign entities that "domesticate" under the laws of a U.S. State.

Proposal

The IRS would be authorized to provide rules for determining whether a partnership is domestic or foreign. Factors to be taken into account might include, for example, the residence of the partners, or whether the partnership is engaged in a U.S. trade or business. The proposal would be effective for taxable years of partnerships beginning after the date of enactment.

ADMINISTRATION OF TAX ON DEPARTING ALIENS: REPEAL "SAILING PERMIT"

Current Law

Section 6851(d) of the Code currently requires any alien who physically leaves the United States -- regardless of the duration of the trip -- to obtain a certificate ("sailing permit") from the IRS District Director prior to departure. The sailing permit is a certificate from the IRS District Director that the alien has complied with all U.S. income tax obligations. It is equivalent to filing a year-to-date tax return with the District Director.

Reasons for Change

Each year, millions of departing aliens are theoretically required to obtain a sailing permit before they depart the United States. Virtually all departing aliens ignore this requirement. Aliens should be required to file a year-to-date tax return only when they permanently leave the United States.

Proposal

The proposal would require any alien resident of the United States who becomes a nonresident to file a tax return within 90 days of the date that he or she ceases to reside in the United States, and pay the relevant tentative tax. This tax would be collected by return, instead of requiring the alien to obtain a certificate from the IRS. No tax return or certificate would be required of a departing alien who intends to maintain residence in the United States.

The proposal would be effective upon date of enactment.

TRANSITION RULE FOR CERTAIN TRUSTS

Current Law

The Internal Revenue Code before 1996 did not provide effective criteria for determining when a trust is foreign. Under legislation enacted in 1996, a trust is considered to be a domestic trust if two factors are present: (1) a court within the United States is able to exercise primary supervision over the administration of the trust; and (2) a U.S. fiduciary (alone or in concert with other U.S. fiduciaries) has the authority to control decisions of the trust. The new rules defining domestic trusts are generally effective for taxable years of a trust that begin after December 31, 1996.

In Notice 96-65, the Internal Revenue Service announced procedures under which a domestic trust in existence on August 20, 1996 may continue to file returns as a domestic trust for taxable years beginning after December 31, 1996, if the trustee initiates modification of the trust to conform to the new domestic trust residence criteria by the due date for filing the trust's return for its first taxable year beginning after 1996 and the trustee completes the modification within two years of such date.

Under legislation enacted in 1996, a domestic trust that becomes a foreign trust is treated as having transferred all of its assets to the foreign trust and is liable for a 35-percent excise tax on the built-in gain in the assets transferred.

Reasons for Change

A number of historically domestic trusts will be treated under the new rules as foreign trusts. It is not necessary to impose the 35-percent excise tax on an existing nongrantor domestic trust that prefers to remain domestic and pay U.S. tax on its worldwide income.

Proposal

The proposal would allow longstanding nongrantor domestic trusts to elect to continue to be treated for tax purposes as domestic trusts, notwithstanding the new statutory definitions. The proposal would be effective for taxable years beginning after December 31, 1996.

MARK-TO-MARKET METHOD OPTION FOR PFIC SHAREHOLDERS

Current Law

The 1986 Act established an anti-deferral regime for passive foreign investment companies (PFICs) and established separate rules for each of two types of PFICs. One set of rules applies to PFICs that are "qualified electing funds," pursuant to which electing U.S. shareholders include currently in gross income their respective shares of a PFIC's total earnings. The second set of rules applies to PFICs that are not qualified electing funds ("nonqualified funds"), whose U.S. shareholders pay tax on income when actually realized as a distribution from a PFIC or a disposition of the PFIC shares, plus an interest charge which is intended to recapture the value of deferral.

The election for treatment as a qualified electing fund, which is made at the shareholder level, is available only where the PFIC complies with certain requirements to provide information and make its books and records available for IRS examination. If the election is in effect for each of the PFIC's taxable years in the investor's holding period for which the company was a PFIC, then no interest charge applies to actual distributions from the PFIC or dispositions of PFIC stock.

Reasons for Change

Some taxpayers who would prefer the current-inclusion method afforded by the qualified electing fund election are not eligible to use it because they can not obtain the required corporate-level information. The alternative set of rules applicable to nonqualified funds are a significant source of administrative complexity and may lead to less desirable tax consequences for PFIC shareholders that are unable to qualify for the current-inclusion regime. In the case of publicly traded PFICs, the market value of the PFIC stock could be used as a proxy for calculating the amount of current earnings of the PFIC, to permit a method of paying current tax on the earnings of the PFIC without obtaining corporate-level information from the PFIC.

Proposal

Under the proposal, shareholders of PFICs with "marketable" stock would be permitted to mark their PFIC shares to market annually. Under the mark-to-market regime, annual mark-to-market gains on PFIC shares would be recognized as ordinary income and any annual mark-to-market losses would be recognized to the extent of previous "unreversed" mark-to-market inclusions with respect to the shares. Appropriate basis adjustment rules and transition rules are included as part of the proposal. The mark-to-market system represents a fair alternative method for measuring income and imposing an appropriate level of income tax on a current basis.

The mark-to-market method would permit shareholders that are unable to make a qualified electing fund election (due to an inability to obtain the requisite corporate-level information) to avoid the economic and administrative burdens associated with the rules applicable to nonqualified funds. In addition, for those shareholders that are able to make a qualified electing fund election, the mark-to-market method would represent a significant simplification for those shareholders over the current inclusion method.

The proposal would be effective for taxable years of U.S. persons beginning after December 31, 1997, and taxable years of foreign corporations ending with or within such taxable years of U.S. persons.

SIMPLIFY THE APPLICATION OF THE STOCK AND SECURITIES TRADING SAFE HARBOR

Current Law

Foreign persons can trade in stocks and securities through an investment fund (organized either as a foreign corporation or as a partnership) that is managed in the United States and, taking advantage of a safe-harbor rule in the tax law, not be subject to U.S. federal income tax on income recognized by the fund. To satisfy the safe harbor the investment fund must not be a dealer in stocks or securities, nor may it maintain its principal office in the United States. The legislative history to the Foreign Investors Tax Act of 1966, which added the stock and securities trading safe harbor to the Code, indicates that the determination of the location of a fund's principal office turns on the location of various back office and other ancillary functions relating to the operation of the fund (including maintenance of the fund's records and books of account, communication with investors and the general public, and solicitation of sales of fund interests) and does not depend on the location of managers or other employees of the fund charged with conducting investment research or making day-to-day business and investment decisions on behalf of the fund. Accordingly, U.S.-based investment funds designed to accommodate foreign investors have developed complex structures under which certain administrative activities of the funds are conducted outside the United States, but research, trading and most other business activities of the funds are conducted within the United States by U.S.-based investment managers with discretionary authority to effect stock and securities transactions on behalf of the funds.

Reasons for Change

The stock and securities trading safe harbor reflects a legislative purpose to promote foreign investment in U.S. capital markets. The principal office requirement of the safe harbor served to address certain tax concerns that became obsolete with the passage of the passive foreign investment company rules in 1986. Since 1986, the principal effects of the principal office requirement have been to shift certain administrative jobs from the United States to foreign tax-haven jurisdictions, and to limit the business opportunities of U.S. investment managers by increasing the cost of organizing and operating U.S.-based investment funds designed to accommodate foreign investors.

Proposal

The proposal would simplify the application of the stock and securities safe harbor by eliminating the principal office requirement. The proposal would be effective for taxable years beginning after December 31, 1996.

SIMPLIFY 10-50 CORPORATION FOREIGN TAX CREDIT LIMITATION BASKETS

Current Law

The 1986 Tax Reform Act created a separate foreign tax credit limitation basket for each so-called "noncontrolled 902" corporation, or "10-50" corporation, that is owned by a U.S. person. A 10-50 corporation is a foreign corporation in which a U.S. person has an ownership interest of at least 10 but not exceeding 50 percent. By contrast, income from all controlled foreign corporations is classified and aggregated by category among the same handful of separate foreign tax credit limitation baskets. Current law provides separate foreign tax credit baskets for each 10-50 corporation because of the difficulty of obtaining the necessary information from a corporation not majority owned in order to "look-through" the corporation to classify its income by category. In the absence of a look-through rule, separate 10-50 baskets serve to prevent taxpayers from forming 10-50 corporations to hold low-tax passive investments, the income from which could be shielded from U.S. tax by excess foreign tax credits from high-tax income of active foreign business operations.

Reasons for Change

Multiple 10-50 baskets impose significant complexity and compliance burdens on taxpayers. Combining the separate 10-50 baskets for active-business entities could greatly reduce compliance burdens. In addition, the somewhat increased ability to mix high- and low-tax income for foreign tax credit purposes would tend to mitigate a bias in current law against U.S. participation in foreign joint ventures and foreign investment by U.S. companies through affiliates that are not majority owned, as compared to the rules applicable to foreign investment by U.S. companies through controlled foreign corporations. The revenue loss caused by increased opportunities to mix active investment income with low-tax passive foreign investment income could be limited by keeping income from any 10-50 corporation that is also a PFIC in its own separate basket.

Proposal

The proposal would merge all 10-50 baskets into a single 10-50 basket, except for 10-50 interests that are passive foreign investment companies (PFICs). Each 10-50 interest that is a PFIC would remain in a separate 10-50 basket. The proposal would be effective for foreign taxes paid or accrued or deemed-paid in taxable years beginning after December 31, 1997.

IMPOSE HOLDING PERIOD REQUIREMENT FOR CERTAIN FOREIGN TAX CREDITS

Current Law

A U.S. person that receives a foreign source dividend generally is entitled to credit income taxes paid to a foreign government with respect to the dividend (or in certain cases, corporate earnings associated with the dividend) regardless of the U.S. person's holding period for the stock with respect to which the dividend is paid. As a consequence of the foreign tax credit limitations of the Code, certain taxpayers are unable to use this credit to reduce U.S. tax. Further, because of their tax-exempt status, pension funds and other non-taxable entities generally are unable to realize value from such a credit.

Reasons for Change

The absence of a holding period requirement for the creditability of foreign taxes associated with foreign source dividends has led certain U.S. persons to engage in inappropriate tax-motivated transactions designed to transfer foreign tax credits from persons that are unable to benefit from such credits to persons that can use the credits to reduce their U.S. tax liability. The transactions sometimes involve a temporary shift in ownership of dividend-paying shares or depositary receipts. Certain of the transactions involve the use of derivatives to effect a shift in legal ownership without a corresponding shift in the normal economic risks of ownership. Growing investment in foreign equity securities by U.S. persons and an expanded market for derivatives has increased the opportunity for U.S. investors to enter into these types of transactions.

Certain transactions effected by taxpayers for purposes of transferring foreign tax credits are complex and raise significant legal issues under current law. The proposal is in part designed to eliminate incentives for taxpayers to engage in these complex transactions and reduce the potential for protracted controversies between taxpayers and the Internal Revenue Service regarding the legal effects of the transactions.

Proposal

The proposal would provide that a taxpayer is not entitled to a tax credit for foreign taxes paid by the taxpayer with respect to a dividend (including foreign taxes treated as paid by the taxpayer by operation of the indirect tax credit rules or the regulated investment company rules) if the taxpayer has not satisfied a 15-day holding period for the dividend-paying stock (or a 46-day period for certain dividends on preferred stock) over a period which includes the date that the taxpayer becomes entitled to receive the dividend. The 15- or 46-day holding period generally would not include any time during which the shareholder is protected from the risk of loss otherwise inherent in the ownership of an equity interest. Taxpayers that fail to satisfy the 15- or 46-day holding period requirement would be allowed a deduction equal to the amount of any foreign tax credits disallowed as a result of the taxpayer's failure to satisfy the holding period requirement. The proposal would be effective for dividends paid or accrued more than 30 days after the date of enactment.

SUBCHAPTER S CONVERSIONS

Current Law

The conversion of a Subchapter S corporation into a partnership is a taxable transaction. The shareholders must liquidate the corporation (incurring both a corporate-level and a shareholder-level tax on liquidation) and reform the entity as a new partnership. This conversion usually results in a prohibitively high tax liability, as well as various transaction costs such as lawyer and accounting fees, and state transfer taxes.

Reasons for Change

The tax and transactions costs of conversion often deter certain Subchapter S corporations from electing the more flexible partnership treatment and thereby prevent them from avoiding the current eligibility restrictions imposed on Subchapter S corporations, such as the number and type of shareholders.

Proposal

An eligible S corporation would be able to elect on a tax-free basis to be treated as a partnership for federal tax purposes provided that it otherwise qualifies for partnership treatment. Eligible S corporations would be limited to (i) S corporations with no old C corporation earning and profit (E&P) and (ii) corporations with remaining built-in corporate gain that elect to recognize the remaining built-in gain on conversion. The proposal would allow S corporations to continue their existing corporate status while converting to partnership treatment for federal tax purposes. An S corporation that wanted to be treated as a partnership would simply file an election, rather than actually transferring its assets to a new partnership and incurring the associated transaction costs. The proposal would be effective for conversions after the date of enactment.

ACCELERATED DUE DATE FOR PARTNERSHIPS, TRUSTS, AND ESTATES TO FURNISH K-1'S

Current Law

A partnership that is 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.

Trustees and executors are also required to provide information to trust and estate beneficiaries regarding the amounts reported on the fiduciary income tax return. Under regulations, this information must be supplied on a Form K-1. The K-1 must be provided to the beneficiary on or before the date on which the trust or the estate's income tax return is due (on or before April 15, for calendar year trusts or estates). This is the same deadline by which most individual beneficiaries must file their tax returns.

Reasons for Change

Individual partners and beneficiaries that do not receive the required information from a partnership or a trust or estate before April 15th must file for an extension of their individual return, even if the partner or beneficiary would not otherwise need to file for an extension.

Proposal

The proposal would provide that a partnership, trust, or estate must furnish information returns to partners or beneficiaries on or before the date that is 30 days prior to the date on which the partnership or fiduciary income tax return is due (on or before March 15, for calendar-year partnerships, trusts, and estates). The proposal would be effective for tax years ending 30 days after date of enactment.

SIMPLIFIED REPORTING AND AUDITING PROVISIONS FOR LARGE PARTNERSHIPS

Current Law

Partnership Reporting. 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.

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 are sold or exchanged.

Partnership Audits. 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 tax treatment of all "partnership items" to be determined at the partnership, rather than the partner, level. Partnership items are those items that are more appropriately determined at the partnership level than at the partner level, as provided by regulations.

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 items consistently with the partnership return, the IRS may make a computational adjustment and immediately assess any additional tax that results.

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.

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. 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.

Individual Retirement Accounts. An individual retirement account ("IRA") is a trust which generally is exempt from taxation except for the taxes imposed on income from an unrelated trade or business. A fiduciary of a trust that is exempt from taxation (but subject to the taxes imposed on income from an unrelated trade or business) generally is required to file a return on behalf of the trust for a taxable year if the trust has gross income of $1,000 or more included in computing unrelated business taxable income for that year.

Unrelated business taxable income is the gross income (including gross income from a partnership) derived by an exempt organization from an unrelated trade or business, less certain deductions with are directly connected with the carrying on of such trade or business. In calculating unrelated business taxable income, exempt organizations (including IRAs) generally also are permitted a specific deduction of $1,000.

Reasons for Change

Requiring each partner of a large partnership to take into account separately his distributive share of each item of partnership income, gain, loss, deduction, and credit (regardless of how many different types of items the partnership may have) imposes a substantial reporting burden on individual partners that hold a small interest in the partnership. Such partners must report their share of each specific income item of the partnership and integrate the partnership items reported on Form K-1 with their individual tax returns, usually resulting in significant complexity for the individual taxpayers.

The current TEFRA auditing regime for large partnerships has given rise to certain technical and procedural difficulties for the IRS and taxpayers in connection with audits of large partnerships. The proposed audit system would result in greater simplification for the IRS, large partnerships, and the partners of large partnerships. In addition, the current TEFRA audit rules have given rise to certain technical ambiguities and uncertainties that should be clarified for partnerships that continue to be subject to the TEFRA audit provisions.

The current filing threshold imposes some practical limitations on an IRAs' investment options. The proposal would effectively broaden the investment options of IRAs to include publicly traded partnerships.

Proposal

Partnership Reporting. The proposal would modify the tax treatment of a large partnership (generally, a partnership with at least 250 partners, or an electing partnership with at least 100 partners) and its partners. Under the proposal, each partner would take 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 or loss to the extent allocable to passive loss limitation activities and other activities; (4) tax-exempt interest; (5) net alternative minimum tax adjustment separately computed for passive loss limitation activities and other activities; (6) general credits; (7) low-income housing credit; (8) rehabilitation credit; (9) credit for producing fuel from a nonconventional source; (10) creditable foreign taxes and foreign source items; and (11) any other items to the extent that the Secretary determines that separate treatment of such items is appropriate.

Separate treatment may be appropriate, for example, should changes in the law necessitate such treatment for any items.

Under the proposal, the taxable income of a large partnership would be computed in the same manner as an individual, except that the items described above would be separately stated and certain modifications would be made. These modifications would include disallowing the deduction for personal exemptions, the net operating loss deduction, and 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 itemized deduction limitations, and any other provision specified in regulations) would be applied at the partnership (and not the partner) level. All elections affecting the computation of taxable income or any credit generally would be made by the partnership.

The proposal would provide that a large partnership would not terminate for tax purposes solely because 50 percent of its interests are sold or exchanged within a 12-month period.

A large partnership would not include any partnership if substantially all the partners are: (1) individuals performing substantial services in connection with the partnership's activities, or personal service corporations the owner-employees of which perform such services; (2) retired partners who had performed such services; or (3) spouses of partners who had performed such services. In addition, the term partner would not include any individual performing substantial services in connection with the partnership's activities and holding a partnership interest, or an individual who formerly performed such services and who held a partnership interest at the time the individual performed such services.

The large partnership rules would not apply to any partnership the principal activity of which is the buying and selling of commodities (not described in section 1221(1)), or options, futures, or forwards with respect to commodities.

In general, a large partnership that otherwise meets the qualifications for simplified reporting would not be required to report information to its partners under the rules of that regime if it is substantially engaged in oil and gas related activities. Rather, such a partnership would continue to report information to its partners as under present law. The proposal would permit such a partnership, however, to elect to utilize the simplified reporting regime, as modified for oil and gas purposes.

Partnership Audits. The proposal would create a new simplified audit system for large partnerships. The proposal would define "large partnership" the same way for audit and reporting purposes (generally partnerships with at least 250 partners), except that certain oil and gas partnerships exempted from the large partnership reporting requirements are large partnerships for the audit rules. In general, under the proposal, partnership adjustments would no longer flow through to partners who were partners in the year to which the adjustment relates. The partnership itself would directly pay any underpayment, except that the Commissioner would be given regulatory authority to flow through the adjustment to the partners who are partners in the year in which the adjustment takes effect in certain circumstances (e.g., certain foreign partnerships).

For partnerships that continue to be subject to the TEFRA audit provisions, the proposal would (1) clarify the treatment of partnership items in deficiency proceedings; (2) permit the IRS to rely on partnership returns to determine the proper audit procedures; (3) clarify various statute of limitations issues; (4) expand the small partnership exception; (5) exclude partial settlements from 1-year assessment rule; (6) extend the time for filing a request for administrative adjustment; (7) provide innocent spouse relief for TEFRA proceedings; (8) determine penalties at the partnership level; (9) clarify the jurisdiction of the Tax Court; (10) address the treatment of premature petitions filed by certain partners; (11) clarify the bond requirement for appeals from TEFRA proceedings; (12) suspend interest when there is a delay in computational adjustment resulting from TEFRA settlements; and (13) extend the time for filing a request for administrative adjustment relating to worthless securities and bad debt.

Individual Retirement Accounts. The proposal would modify the filing threshold for an IRA with an interest in a partnership that is subject to the partnership-level audit rules. A fiduciary of such an IRA could treat the trust's share of partnership taxable income as gross income, for purposes of determining whether the trust meets the $1,000 gross income filing threshold. A fiduciary of an IRA that received taxable income from a partnership that is subject to partnership-level audit rules of less than $1,000 (before the $1,000 specific deduction) would not be required to file an income tax return if the IRA does not have any other income from an unrelated trade or business. The proposal generally would apply to partnership taxable years beginning after December 31, 1997

ELIMINATE GIFT TAX FILING REQUIREMENTS FOR GIFTS TO CHARITIES

Current Law

Under Section 2501 of the Code, a tax generally is imposed for each calendar year on an individual's transfer of property by gift during that calendar year. Section 2522 of the Code provides in part, however, that in computing the amount of taxable gifts made during a calendar year, the taxpayer may deduct the amount of most gifts made to a charity during that year. Generally, this charitable gift deduction is available for outright gifts to charity, as well as gifts of a partial interest in property (such as a remainder interest). A gift of a partial interest in property, however, must be in a prescribed form in order to qualify for the deduction.

Under section 6019 of the Code, an individual donor must file a gift tax return reporting gifts in excess of $10,000 to any one donee during the calendar year (with limited exceptions). This filing requirement applies to all gifts, whether charitable or noncharitable, and whether or not the gift qualifies for a gift tax charitable deduction. Thus, under current law, the return is required even though, because of the deduction authorized by section 2522 for charitable gifts, no gift tax is payable on the transfer.

Reasons for Change

Under current law, the making of a charitable gift in excess of $10,000 triggers the requirement to file a gift tax return, even though the potential gift tax liability will be entirely offset by the gift tax charitable deduction. This is a trap for the unwary, as many charitable donors are not aware of the filing requirement. Failure to file a gift tax return in this situation potentially would expose the donor to a failure to file penalty. Because the charitable gift would be deductible by the taxpayer in computing the amount of taxable gifts made by the taxpayer during the year, eliminating the gift tax return requirement for charitable gifts would not adversely affect tax administration.

Proposal

Gifts to charity that are deductible for gift tax purposes would not be subject to the gift tax filing requirement of section 6019, regardless of the amount of the gift. The proposal would apply to gifts made after December 31, 1997.

CLARIFY ELIGIBILITY FOR EXTENSION OF TIME FOR PAYMENT OF ESTATE TAX

Current Law

Section 6166 of the Code permits estates whose value is largely attributable to the decedent's interest in a closely held business to defer payment of estate taxes for up to five years and to elect to pay the amounts owing in up to ten annual installments. That section further provides that immediate full payment of all deferred estate taxes will become due from an electing estate upon the occurrence of certain events, e.g., disposition of the closely held business.

Current law does not, however, provide an appropriate mechanism for judicial review of disputes regarding initial or continuing eligibility for the deferral and installment elections or disputes regarding the proper amount of installment payments required under section 6166. Thus, court decisions have held that estates would have to prepay the full amount of estate taxes asserted by the Commissioner as being owed in order to obtain judicial review of the Commissioner's determination that the estate either was not initially eligible or had lost its eligibility for the deferrals provided by section 6166.

Reasons for Change

These proposed amendments to the Code will give taxpayers access to the courts to resolve disputes regarding deferral and installment elections under section 6166 without requiring potential disposition of the very estate assets Congress wished to shield from immediate liquidation by permitting the section 6166 election.

Proposal

The proposal would amend the Code to authorize the Tax Court to issue declaratory judgments regarding initial or continuing eligibility for the section 6166 election. The proposal would apply to decedents dying after date of enactment.

CLOSING OF PARTNERSHIP TAXABLE YEAR WITH RESPECT TO DECEASED PARTNER

Current 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 in which the death occurs is taxed to the estate or successor in interest rather than to the decedent on his or her final income tax return.

Reasons for Change

The proposal would coordinate transfers upon death with other transfers of an interest in a partnership and provide for the appropriate allocation of income between the decedent partner and his or her estate or successor in interest.

Proposal

The proposal 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. The proposal would not change present law with respect to the effect upon the partnership taxable year of a transfer of a partnership interest by a debtor to the debtor's estate (under Chapters 7 or 11 of Title 11, relating to bankruptcy). The proposal would be effective for partnership taxable years beginning after December 31, 1997.

MODIFY THROWBACK RULES

Current Law

Nongrantor trusts are taxed similarly to individuals, using a compressed graduated rate structure. The most significant difference between the income taxation of an individual and the taxation of a trust is that a trust is entitled to a distribution deduction for income distributed to a beneficiary. Thus only income accumulated in the trust is taxed to the trust. Before the trust tax rate tables were compressed in 1986, the current income tax bill would often have been lowered by accumulating income in the trust rather than distributing it to a high income bracket beneficiary. Under the throwback rules, when this previously accumulated income is later distributed to a beneficiary, an additional tax is assessed if the beneficiary's highest income tax bracket for the previous five years is higher than that of the trust.

Under section 668, accumulation distributions from a foreign trust are subject to an interest charge for the years from the year of accumulation to the year of the distribution. However, distributions made from corpus rather than income are not subject to the interest charge.

Section 663(a)(1) provides that certain gifts or bequests of a specific sum of money or specific property are not deductible as distribution deductions to a trust or estate, and are not includible in the income of the recipient beneficiary. Thus, a section 663(a)(1) distribution from a foreign trust never carries an interest charge under section 668.

Under Section 644, property transferred to a trust and then sold by the trust at a gain within two years is subject to an additional tax on the precontribution gain based on the difference in tax rate between the trust and the transferor.

Reasons for Change

The throwback rules are very complicated in their application and record keeping requirements. Any time a trust makes an accumulation distribution, the accumulation distribution schedule must be completed, even though additional tax is not usually collected. The interest charge for foreign trusts should be retained as amounts accumulated by a foreign trust generally would not have been subject to U.S. tax when accumulated. The amendments relating to foreign trusts will eliminate two techniques for avoiding the interest charge.

Proposal

The proposal would repeal the throwback rules (sections 666 and 667) and section 644. Section 668 would continue to apply to accumulation distributions from foreign trusts and accumulation distributions from any domestic trust that was a foreign trust at the time of the accumulation, and would be amended to eliminate the ability to avoid the interest charge by accumulating income in a foreign corporation or other entity owned by the foreign trust. Furthermore, the application of section 663(a)(1) would be limited with respect to foreign trusts. The proposal would apply to distributions of income in taxable years beginning after December 31, 1997.

CLARIFY WAIVER OF CERTAIN RIGHTS OF RECOVERY OF ESTATE TAX FROM A QTIP TRUST

Current Law

Property for which a valid qualified terminable interest property (QTIP) election is made is eligible for a marital deduction in a decedent's estate. Under section 2044, the property remaining in the QTIP trust at the time of the surviving spouse's death must be included in the gross estate of the surviving spouse. The surviving spouse's estate has the right to recover the amount of the estate tax attributable to the inclusion of the QTIP trust in the surviving spouse's estate from the recipient of the QTIP trust property. Section 2207A(a)(2) provides that the surviving spouse can waive the right of recovery by will. For this purpose, a will provision specifying that all taxes shall be paid by the estate is sufficient to waive the right of recovery.

Property transferred by the decedent during the decedent's lifetime over which the decedent retained certain rights is also includible in the decedent's gross estate pursuant to section 2036. The decedent's estate has the right to recover the amount of the estate tax attributable to the inclusion of the section 2036 property from the recipient of such property. Section 2207B provides that the decedent can waive the right of recovery by "a provision of his will (or a revocable trust) specifically referring to this section."

Reasons for Change

Current law makes it too easy to inadvertently waive the right of recovery with respect to a QTIP trust. On the other hand, waiver of the right of recovery with respect to section 2036 is too rigid, requiring specific reference to code section 2207B. The proposal would rationalize the two right of recovery provisions in a manner that is more likely to effectuate decedents' actual wishes.

Proposal

The right of recovery with respect to a QTIP trust would be waivable only by a specific provision in the surviving spouse's will (or revocable trust), such as by reference to a QTIP trust, property included under section 2044 or the right of recovery under section 2207A. A general will provision specifying that all taxes shall be paid by the estate would not be sufficient to waive the right of recovery. Similarly, waiver of the right of recovery for section 2036 property under section 2207B could be accomplished by a specific provision in the decedent's will (or revocable trust); however, specific reference to section 2207B would no longer be required. This proposal would apply to decedents dying after date of enactment.

TRANSITIONAL RULE UNDER SECTION 2056A

Current Law

An estate tax marital deduction is not allowed if the recipient spouse is not a citizen of the United States unless the bequest is made or transferred to a qualified domestic trust (QDOT). Under current law, one of the requirements for a QDOT is that at least one trustee be a U.S. citizen or domestic corporation and that no corpus distribution be made from the QDOT unless such U.S. trustee has the right to withhold any estate tax imposed on the distribution. Prior to the enactment of the Omnibus Budget Reconciliation Act of 1989 (OBRA 89), the requirement was that all trustees of a QDOT must be U.S. persons.

Reasons for Change

Under current law, a QDOT established prior to OBRA 89 that complied with the applicable law at that time does not satisfy the current QDOT requirements. This proposal would permit such trusts to qualify. Note that this relief is not extended to QDOTs drafted to comply with the 1990 statutory change, as the requirements of that version were inconsistent with the QTIP requirements and thus cannot be used by taxpayers.

Proposal

A trust created before the enactment of OBRA 89 is treated as satisfying the current law withholding requirement if its governing instrument requires that all trustees be U.S. citizens or domestic corporations. This proposal would be effective as if it were included in the Omnibus Budget Reconciliation Act of 1990.

CLARIFICATIONS RELATING TO CERTAIN DISCLAIMERS

Current Law

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

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

Reasons for Change

The proposal clarifies that transfer-type disclaimers are treated the same as non-transfer-type disclaimers. In addition, the proposal states that disclaimers are effective for income tax purposes as well as for transfer tax purposes, so that if a person disclaims property that is income in respect of a decedent (IRD), the income tax liability for the IRD goes with the disclaimed property.

Proposal

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

AMEND "5 OR 5 POWER"

Current Law

Under Code Section 2514(b), the exercise or release of a general power of appointment constitutes a gift by the person holding the power. An exception is contained in section 2514(e), which states that a lapse of a power during life is a release (and thus a taxable gift) to the extent that the value of the property over which the power lapsed exceeded the greater of $5,000 or 5% of the value of the assets of the trust. Thus lawyers usually draft withdrawal powers in trusts so that they are limited to the greater of these two amounts (this provision is known as the "5-or-5 power"). A similar estate tax provision is in section 2041(b)(2).

Reasons for Change

The 5 or 5 limitation has been in the law since at least 1942. Until 1981, the annual exclusion amount was $3,000 and a trust could have been drafted with a withdrawal right equal to the annual exclusion and easily satisfied the 5 or 5 requirement. With the increase in the annual exclusion to $10,000 in 1981, however, many annual exclusion withdrawal rights have been further limited by the 5 or 5 power.

The burden of this inconsistency has fallen on relatively modest sized trusts (because when the value of the trust assets exceeds $200,000, the 5% limitation would enable the power holder to withdraw $10,000). Practitioners have come up with a series of complicated trust provisions to avoid the taxable lapse of a power. Such techniques include the hanging power (a withdrawal power that "hangs" open, closing only at the 5 or 5 rate), the cascading power (where the purported lapse triggers a power in someone else to prevent the completion of the gift), and the practice of giving withdrawal rights to individuals who have only a remote interest in the trust.

Proposal

In order to simplify trust provisions in this area, the limitation in sections 2514(d) and 2041(b)(2) would be increased to the greater of $10,000 or 5%. Thus, even in smaller trusts, there would be no need to engage in complicated drafting in order to avoid a taxable gift on the lapse of a withdrawal power. This proposal would apply to taxable years beginning after the date of enactment.

EXEMPT CERTAIN SHORT-TERM OID OBLIGATIONS HELD BY A NON-RESIDENT ALIEN FROM U.S. ESTATE TAX

Current Law

The United States imposes its estate tax on estates of individuals who were U.S. citizens or U.S. domiciliaries at the time of their death, and on assets of nondomiciliaries where the assets are situated in the United States at the time of death. Certain special rules apply in determining whether specific types of property are included in the U.S. gross estate. For example, the stock of a domestic corporation is includible in the gross estate of a nonresident alien, notwithstanding its physical location. Debt obligations of a U.S. issuer, including the United States, a political subdivision of a State, or the District of Columbia generally are considered property located within the United States if held by a nonresident not a citizen of the United States.

Interest on certain bank deposits and portfolio debt instruments are exempt from U.S. income tax in the hands of the nonresident recipient. Special estate tax rules treat these items as property situated outside the United States despite the fact that they are obligations of a U.S. issuer. The effect of the special rules is to exclude the items from the U.S. gross estate of a nonresident not a citizen of the United States. However, no equivalent estate tax exemption is available for obligations that generate short-term OID income, despite the fact that such income also is exempt from U.S. income tax in the hands of the nonresident recipient.

U.S. gift tax generally does not apply to transfers of debt instruments by nonresident alien individuals.

Reasons for Change

The income tax and estate tax exemptions for bank deposits, portfolio debt obligations, and short-term OID obligations serve similar purposes and should have similar scopes. The lack of an estate tax exemption for short-term OID instruments acts as a trap for unwary investors who die while holding these obligations.

Description of Proposal

The proposal would treat any debt obligation the income from which would be eligible for the income tax exemption for short-term OID as property located outside of the United States for purposes of determining the U.S. estate tax liability of a nonresident not a U.S. citizen. This would conform the scope of the portfolio interest exemption under the estate tax as applied to short-term OID instruments to the scope of the corresponding exemption under the income tax. The proposal would be effective for decedents dying after the date of enactment.

ESTATE TAX INTEREST DEDUCTIBILITY RULE WITH RATE ADJUSTMENT

Current Law

Estate tax attributable to certain interests in closely held businesses may be paid in installments over 14 years (interest only for four years followed by no more than ten annual installments of principal and interest). A special four-percent interest rate is provided for the tax deferred on the first $1 million of value. The regular IRS rate on tax underpayments applies to values over $1 million. The interest paid is deductible on either the estate tax return or the estate's income tax return (but not both). If an estate elects to take the deduction against the estate tax, annual filings with interrelated computations are required because each payment of interest is allowed as a deduction against the estate tax, thereby reducing the amount of estate tax due and reducing the amount of estate tax that must be deferred.

Reasons for Change

The annual computations involved in claiming an estate tax deduction for interest paid on deferred estate taxes is extremely complex, involving circular computations and interrelated equations. The results of the computations are frequent sources of dispute between taxpayers and the IRS.

Proposal

The proposal would reduce the special 4 percent interest rate on tax deferred on the first $1 million of value to 2 percent. With respect to values in excess of $1 million, the proposal would reduce the interest rate to 45% of the regular IRS rate on tax underpayments. The interest paid on deferred estate tax would not be deductible for estate or income tax purposes.

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

ARBITRAGE REBATE SIMPLIFICATION

Current 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, a yield restriction requirement provides that tax-exempt bond proceeds generally 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 certain specified categories of investments related to the purpose of the issue.

Second, in general, all arbitrage profits earned on investments unrelated to the governmental purpose of the borrowing (i.e., principally earnings on investments not subject to the yield restriction requirement) must be rebated to the Federal government. Arbitrage profits include all such earnings in excess of the bond yield derived from the investment of bond proceeds (and subsequent earnings on any such earnings).

Present law specifies several exceptions to the rebate requirement on nonpurpose arbitrage profits, including generally (1) if gross proceeds of an issue are spent for the purpose of the borrowing within six months after the bonds are issued, no rebate is required, (2) in the case of certain construction bond issues, if the available construction proceeds are spent for the purpose of the borrowing at least at the specified rates during the 24-month period after the bonds are issued, and (3) in the case of governmental bonds issued by issuers with general taxing powers if the issuer does not reasonably expect that the aggregate amount of governmental bonds issued by the issuer will exceed $5 million during a calendar year.

Reasons for Change

State and local government issuers incur the administrative burden of tracking the expenditure and investment of bond proceeds and the calculation of arbitrage in cases where no positive arbitrage is likely to be earned and where no rebate is due. Additional rebate exceptions that track the typical expenditure patterns for state and local government projects and that apply to relatively smaller borrowings where it is unlikely that the borrowing is motivated by a desire to earn arbitrage profits would provide relief for state and local governments.

Proposal

The proposal would create a new rebate exception and expand the $5 million small issuer exception to $10 million. The first proposal would exempt from rebate long-term fixed-rate governmental tax-exempt bonds in cases where all bond proceeds are spent within the general three-year temporary period. Under the proposal, no rebate (other than on reasonably required reserve and replacement funds or sinking funds) would be required if at least 15% of the spendable proceeds were spent within one year of the date of issuance and at least 100% of the spendable proceeds were spent within three years of the date of issuance (with an exception if at least 95% are spent within three years and the remaining are spent within 6 months after that date). Long-term bonds would be defined to include bonds with a weighted average maturity of at least 10 years, with a provision for short-term bond anticipation notes that were expected to be refinanced with bonds having a weighted average maturity of 10 years or more. The exception would be available to issues with a reasonably required reserve and replacement fund or sinking fund if the proceeds in such funds were either invested at a restricted yield in U.S. Treasury Securities - State and Local Government Series or if the issuer rebated any arbitrage from such funds to the Federal government.

Second, the proposal would expand the current $5 million small issuer rebate exception to issuers with general taxing power that did not reasonably expect to issue more than a $10 million aggregate amount of governmental bonds in a calendar year. To qualify for this exception, any proceeds in a sinking fund for the issue would be required to be invested at a restricted yield in U.S. Treasury Securities - State and Local Government Series or would be subject to the rebate requirement.

In both cases, issuers would continue to be subject to the expected spending benchmarks of the hedge bond provisions of the Code and the artifice and device provisions in the regulations to prevent issuers from issuing bonds earlier than warranted by standard municipal financial practices. The proposal would be effective for bonds issued after the date of enactment.

REPEAL OF $100,000 LIMITATION ON UNSPENT PROCEEDS FROM TAX-EXEMPT BOND ISSUES UNDER 6-MONTH REBATE EXCEPTION

Current Law

In general, issuers of state and local government bonds are required to rebate to the Federal government arbitrage profits from investing proceeds of tax-exempt bonds. No rebate of arbitrage profits is required if the gross proceeds of an issue are spent for the governmental purpose of the borrowing within six months after issuance. In the case of governmental bonds and qualified 501(c)(3) bonds, the six-month expenditure test is met if all proceeds other than an amount not exceeding the lesser of 5% of the proceeds or $100,000 have been spent within six months and the remaining de minimis amount is spent within the next six months.

Reasons for Change

The six-month rebate exception eliminates the need for issuers of state and local government bonds to calculate rebate in cases where the arbitrage profits are less likely to be earned because of the short time the proceeds are invested. More issuers would be able to fall within the exception if the $100,000 limit on unspent proceeds were eliminated.

Proposal

The proposal would eliminate the $100,000 limitation and define the de minimis amount of unspent proceeds for purposes of this rebate exception as 5% of the proceeds for bonds issued after the date of enactment.

EXCLUSION FROM ARBITRAGE REBATE FOR EARNINGS ON BONA FIDE DEBT SERVICE FUND UNDER CONSTRUCTION BOND RULES

Current Law

In general, issuers of state and local government bonds are required to rebate to the Federal government arbitrage profits from investing proceeds of tax-exempt bonds. An exception from the rebate requirement is provided for governmental bonds, exempt facility private activity bonds for governmentally-owned property or qualified 501(c)(3) construction bonds. This exception applies if the available construction proceeds of an issue are spent at minimum specified rates during the 24-month period after the bonds are issued. This exception does not apply to bond proceeds invested after the 24-month period as part of a bona fide debt service fund, reserve fund or certain sinking funds. An issuer can elect to make a penalty payment in lieu of rebate on unspent proceeds.

Reasons for Change

An issuer is able to reduce the burden of calculating rebate for issues that meet the two-year construction bond rebate exception. In cases where the issuer has no reserve or sinking fund, however, the issuer must still track proceeds deposited in a bona fide debt service fund. There is less likelihood that rebate will be earned in a bona fide debt service fund because the fund is invested short-term to make current debt service payments on the bonds. More issuers would be able to reduce or eliminate rebate calculations if they were not required to track investments in a bona fide debt service fund.

Proposal

The proposal would exempt earnings on bond proceeds invested in a bona fide debt service fund from rebate or the penalty payment after the 24-month period if the spending requirements of that exception are otherwise satisfied for bonds issued after the date of enactment.

REPEAL OF DEBT SERVICE-BASED LIMITATION ON INVESTMENT IN CERTAIN NONPURPOSE INVESTMENTS

Current Law

Issuers of state and local government bonds are required to restrict the yield on the investment of proceeds of tax-exempt bonds to the yield on the tax-exempt bonds. Exceptions to the yield restriction requirement are provided for certain temporary periods. In addition, current law limits the amount of proceeds of private activity bonds (other than qualified 501(c)(3) bonds) that may be invested at a materially higher yield at any time during a bond year to 150% of the debt service for that bond year. Issuers of state and local government bonds are also required to rebate any arbitrage profits that are earned from the investment of tax-exempt bond proceeds to the Federal government.

Reasons for Change

The yield restriction limit imposed if amounts invested exceed 150% of debt service in a bond year primarily affects investments in reserve or sinking funds. The tracking of the size of these funds imposes administrative burdens on issuers. These funds are already subject to statutory and regulatory rules on the size of the reserve fund, and any arbitrage profits would be subject to rebate.

Proposal

The proposal would eliminate the 150% of debt service yield restriction requirement for bonds issued after the date of enactment.

REPEAL OF EXPIRED STUDENT LOAN BOND ARBITRAGE REBATE PROVISIONS

Current Law

Issuers of state and local government bonds are required to restrict the yield on the investment of proceeds of tax-exempt bonds to the yield on the tax-exempt bonds, subject to exceptions for temporary periods. In the case of a pooled bond issue where proceeds of the bonds are loaned to two or more persons, the general temporary period for unrestricted investment is six months. Current law extends this six-month period to 18 months for certain student loan pool bonds issued before January 1, 1989. In calculating rebate, issuers of certain student loan bonds are not required to take certain administrative fees into account in determining investment proceeds for purposes of determining arbitrage profits. This exception applies only to bonds issued before January 1, 1989.

Reasons for Change

These exceptions apply only to bonds issued before January 1, 1989, and thus represent "deadwood" provisions.

Proposal

The proposal would repeal these provisions effective after the date of enactment.

INCREASE DE MINIMIS LIMIT FOR AFTER-MARKET ALTERATIONS FOR HEAVY TRUCK AND LUXURY CAR EXCISES

Current Law

An excise tax is imposed on retail sales of truck chassis and truck bodies suitable for use in a vehicle with a gross vehicle weight of over 33,000 pounds. The tax is equal to 12 percent of the retail sales price. An excise tax is also imposed on retail sales of luxury automobiles. The tax is currently equal to 8 percent of the amount by which the retail sales price exceeds an inflation-adjusted $30,000 base. (The rate is reduced by 1 percentage point per year through 2002, and the tax is not imposed after 2002.) Anti-abuse rules prevent the avoidance of these taxes through separate purchases of major component parts. With certain exceptions, tax at the rate applicable to the vehicle is imposed on the subsequent installation of parts and accessories. The exceptions include a de minimis rule for parts and accessories with an aggregate price that does not exceed $200 (or such other amount as Treasury may by regulation prescribe). In addition, the tax on luxury automobile additions does not phase down as the tax applicable to the automobiles phases down.

Reasons for Change

Retailers are generally responsible for taxes on truck chassis and bodies and luxury automobiles. In the case of a subsequent installation, however, the owner or operator of the vehicle is responsible for paying the tax attributable to the installation and the installer is secondarily liable. Increasing the de minimis amount should significantly reduce the number of return filers and relieve many persons from the administrative burden of filing an excise tax return reporting a very small amount of tax.

Proposal

The tax on subsequent installation of parts and accessories would not apply to parts and accessories with an aggregate price that does not exceed $1,000. The provision would apply to parts and accessories installed after December 31, 1997. Parts and accessories installed on a vehicle on or before that date would be taken into account in determining whether the $1,000 threshold is exceeded. If the aggregate price of the pre-1998 parts and accessories does not exceed $200, they would not be subject to tax unless the aggregate price of all additions exceeds $1,000.

Beginning on the date of enactment, the tax on luxury automobile additions would be phased down on the same schedule as the tax on luxury automobiles.

SIMPLIFICATION OF EXCISES ON DISTILLED SPIRITS, WINES AND BEER

Current Law

Imported Distilled Spirits Returned to Plant. Excise tax that has been paid on domestic distilled spirits is credited or refunded if the spirits are later returned to bonded premises. Tax is imposed on imported bottled spirits when they are withdrawn from customs custody, but the tax is not refunded or credited if the spirits are later returned to bonded premises.

Cancellation of Export Bonds. 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."

Location of Records of Distilled Spirits Plant. 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 record are carried on.

Transfers from Brewery to Distilled Spirits Plant. A distilled spirits plant may receive on its bonded premises beer to be used in the production of distilled spirits only if the beer is produced on contiguous brewery premises.

Sign Not Required for Wholesale Dealers. Wholesale liquor dealers are required to post a sign identifying the firm as such. Failure to do so is subject to a penalty.

Refund on Returns of Merchantable Wine. 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.

Increased Sugar Limits for Certain Wine. Natural wines may be sweetened to correct high acid content. For most wines, however, sugar cannot constitute 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. If the amount of sugar used exceeds the applicable limitation, the wine must be labeled "Substandard."

Beer Withdrawn for Embassy Use. Imported beer to be used for the family and official use of representatives of foreign governments or public international organizations may be withdrawn from customs bonded warehouses without payment of excise tax. No similar exemption applies to domestic beer withdrawn from a brewery or entered into a bonded customs warehouse for the same authorized use.

Beer Withdrawn for Destruction. Removals of beer from a brewery are exempt from tax if the removal is for export, because the beer is unfit for beverage use, for laboratory analysis, research, development and testing, for the brewer's personal or family use, or as supplies for certain vessels and aircraft.

Drawback on Exported Beer. 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.

Imported Beer Transferred in Bulk to Brewery. Imported beer is subject to tax when removed from customs custody.

Reasons for Change

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 excise taxes.

A number of reporting and recordkeeping requirements should be modified to conform to the current collection system. Appropriate modifications would allow the Bureau of Alcohol, Tobacco, and Firearms to administer alcohol excise taxes more efficiently and relieve taxpayers of unnecessary paperwork burdens.

The current rules under which the Code permits tax-free removals of alcoholic beverages (or allows a credit or refund of tax on a return to bonded premises) result in inappropriate disparities in the treatment of different types of alcoholic beverages. In addition, these rules unduly limit available options for complying with environmental and other laws that regulate the destruction and disposition of alcoholic beverages. Under the bonded premises system, these rules can be liberalized without jeopardizing the collection of tax revenues.

Other provisions of current law (i.e., the sign requirement and the sugar limits for certain wine) are outmoded and should be repealed or revised.

Proposals

Imported Distilled Spirits Returned to Plant. Refunds or credits of the tax would be available for imported bottled spirits that are returned to distilled spirits plants.

Cancellation of Export Bonds. The certification requirement would be relaxed to allow the bonds to be canceled if there is such proof of exportation as the Secretary may require.

Location of Records of Distilled Spirits Plant. Records and reports would be permitted to be maintained elsewhere other than on the plant premises.

Transfers from Brewery to Distilled Spirits Plant. Beer could be brought from any brewery for use in the production of spirits. Such beer would be exempt from excise tax, subject to Treasury regulations.

Sign Not Required for Wholesale Dealers. The requirement that a sign be posted would be repealed.

Refund on Returns of Merchantable Wine. A refund or credit would be available in the case of all domestic wine returned to bond, whether or not unmerchantable.

Increased Sugar Limits for Certain Wine. Up to 60 percent sugar would be permitted 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. Subject to Treasury's regulatory authority, an exemption similar to that available for imported beer would be provided for domestic beer.

Beer Withdrawn for Destruction. An exemption from tax would be added for removals for destruction, subject to Treasury regulations.

Drawback on Exported Beer. The certification requirement would be relaxed to allow a drawback of tax paid if there is such proof of exportation as the Secretary may by regulations require.

Imported Beer Transferred in Bulk to Brewery. Subject to Treasury regulations, beer imported in bulk could be withdrawn from customs custody and transferred in bulk to a brewery without payment of tax. The proprietor of the brewery to which the beer is transferred would be liable for the tax imposed on the withdrawal from customs custody and the importer would be relieved of liability.

The proposal to repeal the requirement that wholesale liquor dealers post a sign outside their place of business would take effect on the date of enactment. The other proposals would take effect on the first day of the calendar quarter that begins at least 90 days after the date of enactment.

AUTHORITY FOR IRS TO GRANT EXEMPTIONS FROM EXCISE TAX REGISTRATION REQUIREMENTS.

Current Law

The Code exempts certain types of sales (e.g., sales for use in further manufacture, sales for export, and sales for 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 Internal Revenue Service. The IRS can waive the registration requirement for the purchaser and second purchaser in some but not all cases.

Reasons for Change

Allowing the IRS to waive the registration requirement for purchasers and second purchasers in all cases will permit more efficient administration of the exemptions and reduce paperwork burdens on taxpayers.

Proposal

The IRS would be allowed to waive the registration requirement for purchasers and second purchasers in all cases. The proposal would apply to sales made pursuant to waivers issued after the date of enactment.

REPEAL OF EXCISE TAX DEADWOOD PROVISIONS

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.

Reasons for Change

The elimination of deadwood provisions contributes to a shorter, simpler Internal Revenue Code.

Proposal

The provisions would be repealed effective on the date of enactment.

EXTEND DUE DATE FOR FIRST QUARTER ESTIMATED TAX OWED BY PRIVATE FOUNDATIONS

Current Law

Section 4940 imposes an excise tax on the investment income of a private foundation. Each foundation is required to make estimated payments of the excise tax at quarterly intervals during the year. To avoid an addition to tax, the private foundation must make estimated tax payments that equal at least 100% of the lesser of the tax shown on its return for the taxable year or the previous taxable year. Section 6655(g)(3) specifies that the due date for the private foundation's first estimated payment of excise taxes is the same as that for corporate estimated payments of income taxes, i.e., April 15.

Reasons for Change

Private foundations typically rely on the amount of tax owed for the preceding taxable year to ensure they pay sufficient estimated tax, and they usually do not calculate their previous year's tax liability until shortly before their returns are due, i.e. May 15. Conforming the due date for the estimated tax payment and the filing of the private foundation's annual information return will make it simpler for private foundations to ensure they are making adequate estimated tax payments.

Proposal

The proposal would extend the due date for the first estimated tax payment for private foundations by one month, from April 15 to May 15 or the 15th day of the fifth month of the taxable year. The proposal would be effective for taxable years beginning after the date of enactment.

CLARIFICATION OF AUTHORITY TO WITHHOLD PUERTO RICO TAXES FROM SALARIES OF FEDERAL EMPLOYEES

Current Law

If State law provides generally for the withholding of state income taxes from the wages of employees in a State, the Secretary of the Treasury shall (upon the request of the State) enter into an agreement with the State providing for the withholding of State income taxes from the wages of federal employees in the state. For this purpose, the term "State" includes a State, territory, or possession of the United States.

Reasons for Change

The Court of Appeals for the Federal Circuit held in Romero v. United States, 38 F.3d 1204 (1994), that Puerto Rico was not encompassed in the above definition of a State; consequently, the court invalidated an agreement between the Secretary of the Treasury and Puerto Rico that provided for the withholding of Puerto Rico income taxes from the wages of federal employees. The proposal would correct this anomaly under current law.

Proposal

Under the proposal, any Commonwealth of the United States would be eligible to enter into an agreement with the Secretary of the Treasury that would provide for income tax withholding from the wages of federal employees. The proposal would be effective on the date of enactment.

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

Current Law

The IRS is generally not authorized to provide services to non-federal agencies even if the cost is reimbursed. 62 Comp. Gen. 323, 335 (1983). Taxpayers currently must file returns with both their State taxing agency and the IRS, and frequently must resolve issues with the agencies at different times.

Reasons for Change

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

Proposal

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