General Explanations
of the
Administration's Revenue Proposals

Department of the Treasury
February 1995

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TAX CREDIT FOR DEPENDENT CHILDREN

Current Law

A tax exemption, in the form of a deduction, is allowed for each taxpayer and for each dependent of a taxpayer. A dependent includes a child of the taxpayer who is supported by the taxpayer and is under age 19 at the close of the calendar year or is a student under age 24. The deduction amount is $2,500 for tax year 1995. This amount is indexed annually for inflation.

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

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

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

Reasons for Change

Tax relief for middle-class families has been and continues to be an important goal of this Administration. In 1993, the Administration faced a projection of ever-increasing deficits. Bringing the deficit under control and providing tax relief for the working poor through an expansion of the EITC were the first priorities. Having achieved more favorable than projected results from the deficit reduction program introduced in 1993, the Administration can now turn to providing tax relief to middle-income families.

Tax relief to taxpayers with children is needed to adjust the relative tax burdens of smaller and larger families to reflect more accurately their relative abilities to pay taxes. Available resources should be targeted to those in greatest need and at greatest risk.

Proposal

A nonrefundable tax credit, which would be applied after the EITC, would be allowed for each dependent child under age 13. It would be phased in, at $300 per child for tax years 1996, 1997, and 1998, and $500 per child for 1999 and thereafter. The credit would not reduce any alternative minimum tax liability. The credit would be phased out for

taxpayers with adjusted gross income between $60,000 and $75,000. Beginning in the year 2000, both the amount of the credit and the phase-out range would be indexed for the effects of inflation.

Taxpayers claiming the dependent child credit would be required to provide valid social security numbers for themselves, their spouses, and their children who qualify for the credit. The procedures that would apply for determining the validity of social security numbers under the EITC, discussed below, would apply for purposes of the dependent child credit.

Revenue Estimate (in billions of dollars)

	Fiscal Years						
	1995	1996	1997	1998	1999	2000	Total
Tax credit for dependent children	0	-3.5	-6.8	-6.6	-8.3	-10.1	-35.4

EDUCATION AND JOB TRAINING TAX DEDUCTION

Current Law

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

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

The interest from qualified U.S. savings bonds is excluded from a taxpayer's gross income to the extent the interest is used to pay qualified educational expenses. To be qualified, the savings bonds must be purchased after December 31, 1989, by a person who has attained the age of 24. Qualified educational expenses consist of tuition and fees for enrollment of the taxpayer, the taxpayer's spouse, or the taxpayer's dependent at a public or non-profit institution of higher education, including two-year colleges and vocational schools.

Reasons for Change

Deductions for educational expenses combine needed tax relief with preparation for new economic imperatives. The expenses of higher education place a significant burden on many middle-class families. Grants and subsidized loans are available to students from low- and moderate-income families; high-income families can afford the costs of higher education.

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

Proposal

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

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

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

In 1996, 1997, and 1998, the maximum deduction would be $5,000. In 1999 and thereafter, this maximum would increase to $10,000. The deduction would be phased out ratably for taxpayers with modified AGI between $70,000 and $90,000 ($100,000 and $120,000 for joint returns). Modified AGI would include taxable Social Security benefits and amounts otherwise excluded with respect to income earned abroad (or income from Puerto Rico or U.S. possessions). Beginning in 2000, the income phase-out range would be indexed for inflation.

Any amount taken into account as a qualified educational expense would be reduced by educational assistance that is not required to be included in the gross income of either the student or the taxpayer claiming the deduction. Thus, qualified educational expenses would be reduced by scholarship or fellowship grants excludable from gross income under section 117 of the Internal Revenue Code (even if the grants are used to pay expenses other than qualified educational expenses) and any educational assistance received as veterans' benefits. However, no reduction would be required for a gift, bequest, devise or inheritance within the meaning of section 102(a).

An eligible student would be one who is enrolled or accepted for enrollment in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an eligible institution. The student must pursue a course of study on at least a half-time basis, cannot be enrolled in an elementary or secondary school, and cannot be a nonresident alien. Educational institutions would determine what constitutes a half-time basis for individual programs.

"Eligible institution" is defined by reference to section 481 of the Higher Education Act. Such institutions must have entered into an agreement with the Department of Education to participate in the student loan program. This definition includes certain proprietary institutions.

This proposal would not affect deductions claimed under any other section of the Code, except that any amount deducted under another section of the Code could not also be deducted under this provision. An eligible student would not be eligible to claim a deduction under this provision if that student could be claimed as a dependent of another taxpayer.

Revenue Estimate (in billions of dollars)

	Fiscal Years						
	1995	1996	1997	1998	1999	2000	Total
Education and job training tax deduction	0	-0.7	-4.7	-4.9	-5.7	-7.5	-23.5

EXPANDED INDIVIDUAL RETIREMENT ACCOUNTS

Current Law

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

The earnings on IRA account balances are not included in income until they are withdrawn. Withdrawals from an IRA (other than withdrawals of nondeductible contributions) are includable in income, and must begin by age 70½. Amounts withdrawn before age 59½ are generally subject to an additional 10 percent penalty tax. The penalty tax does not apply to distributions upon the death or disability of the taxpayer or withdrawals in the form of substantially equal periodic payments over the life (or life expectancy) of the IRA owner or over the joint lives (or life expectancies) of the IRA owner and his or her beneficiary.

Reasons for Change

The nation's savings rate has declined dramatically since the 1970s. The Administration believes that increasing the savings rate is essential if the United States is to sustain a sufficient level of private investment into the next century. Without adequate investment, the continued healthy growth of the economy is at risk. The Administration is also concerned that many households are not saving enough to provide for long-term needs such as retirement and education.

The Administration believes that individuals should be encouraged to save, and that tax policies can provide a significant incentive. Under current law, however, savings incentives in the form of deductible IRAs are not available to all middle-income taxpayers. Furthermore, the present-law income thresholds for deductible IRAs and the maximum contribution amount are not indexed for inflation, so that fewer Americans are eligible to make a deductible IRA contribution each year, and the amount of the maximum contribution is declining in real terms over time. The Administration also believes that providing taxpayers with the option of making IRA contributions that are nondeductible but can be withdrawn tax free will provide an alternative savings vehicle that some middle-income taxpayers may find more suitable for their savings needs.

Individuals save for many purposes besides retirement. Broadening the tax incentives for non-retirement saving can be an important element in any proposal to increase the nation's savings rate. Expanding the flexibility of IRAs to meet a wider variety of savings needs, such as first-time home purchases, higher education expenditures, unemployment and catastrophic medical and nursing home expenses, should prove to be more attractive to many taxpayers than accounts limited to retirement savings.

<u>Proposal</u>

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

Under the proposal, the IRA contribution limit would be coordinated with the current law limits on elective deferrals under qualified cash or deferred arrangements (sec. 401(k) plans), tax-sheltered annuities (sec. 403(b) annuities), and similar plans. The proposal also would provide that the present-law rule permitting penalty-free IRA withdrawals after an individual reaches age 59½ does not apply in the case of amounts attributable to contributions made during the previous five years. This provision does not apply to amounts rolled over from tax-qualified plans or tax-sheltered annuities.

These provisions would be effective January 1, 1996.

Special IRAs. Each individual eligible for a traditional deductible IRA would have the option of contributing an amount up to the contribution limit to either a deductible IRA or to a new "Special IRA." Contributions to a Special IRA would not be deductible, but if the contributions remained in the account for at least five years, distributions of the contributions and the earnings thereon would be tax-free. Withdrawals of earnings from Special IRAs during the five-year period after contribution would be subject to ordinary income tax. In addition, such withdrawals would be subject to the 10-percent penalty tax on early withdrawals unless used for one of the four purposes described below.

The proposal would permit individuals whose AGI for a taxable year did not exceed the upper end of the new income eligibility limits to convert balances in deductible IRAs into Special IRAs without being subject to the 10-percent tax on early withdrawals. The amount transferred from the deductible IRA to the Special IRA generally would be includable in the individual's income in the year of the transfer. However, if a transfer was made before January 1, 1997, the transferred amount included in the individual's income would be spread evenly over four taxable years.

The Special IRA provisions would be effective January 1, 1996.

Penalty-Free Distributions. Amounts could be withdrawn penalty-free from deductible IRAs and Special IRAs within the five-year period after contribution, if the taxpayer used the amounts to pay post-secondary education costs, to buy or build a first home, to cover living costs if unemployed, or to pay catastrophic medical expenses (including certain nursing home costs).

a. Education expenses

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

b. First-time home purchasers

Penalty-free withdrawals would be allowed to the extent the amount withdrawn is used to pay qualified acquisition, construction, or reconstruction costs with respect to a principal residence of a first-time home buyer who is the taxpayer, the taxpayer's spouse, or the taxpayer's child or grandchild. A first-time home buyer would be any individual (and if married, the individual's spouse) who (1) did not own an interest in a principal residence during the three years prior to the purchase of a home and (2) was not in an extended period for rolling over gain from the sale of a principal residence.

c. Unemployment

Penalty-free withdrawals could be made by an individual after the individual is separated from employment if (1) the individual has received unemployment compensation for 12 consecutive weeks and (2) the withdrawal is made in the taxable year in which the unemployment compensation is received or the succeeding taxable year.

d. Medical care expenses and nursing home costs

The proposal would extend to IRAs the present-law exception to the early withdrawal tax for distributions from tax-qualified plans and tax-sheltered annuities for certain medical care expenses (deductible medical expenses that are subject to a floor of 7.5 percent of AGI) and expand the exception for IRAs to allow withdrawal for medical care expenses of the taxpayer's child, grandchild, parent or grandparent, whether or not such person otherwise qualifies as the taxpayer's dependent.

In addition, for purposes of the exemption from the 10 percent tax on early withdrawals for distributions from IRAs, the definition of medical care would include expenses for qualified long-term care services for incapacitated individuals. Qualified long-term care services generally would be services that are required by an incapacitated individual, where the primary purpose of the services is to provide needed assistance with any activity of daily living or protection from threats to health and safety due to severe cognitive impairment. An incapacitated individual generally would be a person who is certified by a licensed professional within the preceding 12-month period as being unable to perform without substantial assistance at least two activities of daily living, or as having severe cognitive impairment.

These provisions would be effective January 1, 1996.

Revenue Estimate (in billions of dollars)

	Fiscal Years						
	1995	1996	1997	1998	1999	2000	Total
Expanded individual retirement accounts	0	0.4	-0.3	-0.8	-1.0	-2.0	-3.8

INCREASE IN NUMBER OF EMPOWERMENT ZONES

Current Law

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

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

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

Reasons for Change

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

Proposal

The proposal would authorize the designation of two additional urban empowerment zones and would be effective on the date of enactment. No additional federal grants would be authorized. The sole effect of the proposal would be to extend the empowerment zone tax incentives to two additional areas.

Revenue Estimate (in billions of dollars)

	Fiscal Years						
	1995	1996	1997	1998	1999	2000	Total
Increase in number of Empowerment Zones	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.7

REDUCE VACCINE EXCISE TAXES

Current Law

The Vaccine Injury Compensation Program provides compensation for individuals who suffer certain injuries following the administration of the following vaccines: diphtheria, pertussis, and tetanus (DPT); diphtheria and tetanus (DT); measles, mumps, and rubella (MMR); and polio. Compensation is paid from the Vaccine Injury Compensation Trust Fund (Vaccine Trust Fund), which is funded by net revenues from a manufacturer's excise tax on DPT, DT, MMR, and polio vaccines. The excise tax per dose is $4.56 for DPT, $0.06 for DT, $4.44 for MMR, and $0.29 for polio vaccines. A vaccine for measles only, mumps only, or rubella only is taxed at the full MMR rate.

The Vaccine Injury Compensation Program provides compensation for adverse reactions to a vaccine only if the vaccine is included in the Vaccine Injury Table prescribed by the Department of Health and Human Services and is subject to the vaccine excise tax.

Reasons for Change

The Vaccine Trust Fund is overfunded. At the end of FY 1994 the trust fund balance was $809 million and, at current tax rates, transfers to the trust fund will continue to exceed outlays by over $50 million per year. While the current trust fund balance is an appropriate reserve against any unexpected increase in awards, future transfers to the trust fund should be brought in line with expected outlays by a reduction in the tax.

It is expected that *haemophilis influenzae* type b (Hib) and hepatitis type B (Hep B) vaccines, which are now routinely recommended for administration to children, will be added to the Vaccine Injury Table before the end of 1995. Those vaccines should also be added to the list of taxed vaccines.

Proposal

The Administration will submit a proposal to restructure the vaccine excise taxes. Revenues from these taxes will be reduced to approximately half the amounts expected under current law.

Revenue Estimate (in billions of dollars)[1]

	Fiscal Years						
	1995	1996	1997	1998	1999	2000	Total
Reduce vaccine excise taxes	0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.3

[1] Net of income tax offset.

EARNED INCOME TAX CREDIT COMPLIANCE PROPOSALS

Current Law

To be eligible for the Earned Income Tax Credit (EITC), a taxpayer must reside in the United States for over six months. Nonresident aliens are not entitled to the EITC beginning in 1995. Other non-U.S. citizens are eligible for the EITC if, among other things, they meet a six-month residency requirement and do not file an income tax return as a non-resident alien.

To claim the higher EITC amounts available to taxpayers with qualifying children, those taxpayers are required to provide taxpayer identification numbers (TINs) for each qualifying child. Unless otherwise proscribed by regulation, social security numbers serve as TINs. Some taxpayers are unable to obtain social security numbers. Under section 205(c) of the Social Security Act, social security numbers are generally issued only to individuals who are citizens or who are authorized to work in the U.S. Undocumented workers may not be able to obtain social security numbers.

The IRS must follow deficiency procedures when investigating questionable EITC claims. First, contact letters are sent to the taxpayer. If the necessary information is not provided by the taxpayer, a statutory notice of deficiency is sent by certified mail, notifying the taxpayer that the adjustment will be assessed unless the taxpayer files a petition in Tax Court within 90 days. If a petition is not filed within that time and there is no other response to the statutory notice, the assessment is made and the EITC is denied.

Reasons for Change

The Administration believes that the EITC should not be available to individuals who are not authorized to work in the United States. During the past year, the Administration and Congress have taken steps to improve the administration of the EITC. Further steps are desirable to ensure that only the intended beneficiaries receive the EITC.

Proposal

Only individuals who are authorized to work in the United States would be eligible for the EITC. Taxpayers claiming the EITC would be required to provide a valid social security number for themselves, their spouses, and qualifying children. Social security numbers would have to be valid for employment purposes in the United States. Thus, eligible individuals would include U.S. citizens and lawful permanent residents. Taxpayers residing in the United States illegally would not be eligible for the credit.

In addition, the IRS would be authorized to use the math-error procedures, which are simpler than deficiency procedures, to resolve questions about the validity of a social security number. Under this approach, the failure to provide a correct social security number would

be treated as a math error. Taxpayers would have 60 days in which they could either provide a correct social security number or request that the IRS follow the current-law deficiency procedures. If a taxpayer failed to respond within this period, he or she would be required to refile with correct social security numbers in order to obtain the EITC.

These provisions would be effective for tax years beginning after December 31, 1995.

Revenue Estimate (in billions of dollars)[2]

	Fiscal Years						
	1995	1996	1997	1998	1999	2000	Total
EITC compliance proposals	0	0	0.4	0.5	0.5	0.5	1.9

[2] Includes reduction in outlays.

INTEREST AND DIVIDEND TEST FOR EARNED INCOME TAX CREDIT

Current Law

To be eligible to receive the Earned Income Tax Credit (EITC), an individual must have earned income. To target the EITC to low-income workers, the amount of the credit to which a taxpayer is entitled decreases when the taxpayer's earned income (or, if greater, adjusted gross income (AGI)) exceeds certain thresholds. The earned income and AGI thresholds are indexed for inflation and are also adjusted to take into account qualifying children. In 1995, a taxpayer with two or more qualifying children will not be eligible for the EITC if his or her income exceeds $26,673. The income cut-offs decline to $24,396 for a taxpayer with one qualifying child and $9,230 for a taxpayer with no qualifying children.

Reason for Change

Under current law a taxpayer may have relatively low earned income, and therefore may be eligible for the EITC, even though he or she has significant interest and dividend income. The EITC should be targeted to families with the greatest need. Most EITC recipients do not have significant resources and must rely on earnings to meet their day-to-day living expenses, but taxpayers with high levels of interest and dividend income can draw upon the resources that produce this income to meet family needs.

Proposal

Beginning in 1996, a taxpayer would not be entitled to the EITC if his or her aggregate interest and dividend income during a taxable year exceeds $2,500. This threshold would be indexed for inflation thereafter.

Revenue Estimate (in billions of dollars)[3]

	Fiscal Years						
	1995	1996	1997	1998	1999	2000	Total
Interest and dividend test for Earned Income Tax Credit	0	*	0.3	0.3	0.4	0.4	1.4

* Revenue gain of less than $50 million

[3] Includes reduction in outlays.

TAX RESPONSIBILITIES OF AMERICANS WHO RENOUNCE CITIZENSHIP

Current Law

Under current law, worldwide gains realized by U.S. citizens and resident aliens are subject to U.S. tax. Existing rules recognize that the United States has a tax interest in preventing tax avoidance through renunciation of citizenship. These rules continue to tax former U.S. citizens on U.S. source income for ten years following renunciation of citizenship if one of the principal purposes of the renunciation was to avoid U.S. income tax. A similar rule applies to aliens who cease to be residents.

Reasons for Change

Wealthy U.S. citizens and long-term residents sometimes abandon their U.S. citizenship or status as residents. Existing rules to prevent tax avoidance through expatriation have proven largely ineffective because departing taxpayers have found ways to restructure their activities to avoid those rules, and compliance with the rules is difficult to monitor. Consequently, existing measures need to be enhanced to ensure that gains generally accruing during the time a taxpayer was a citizen or long-term permanent resident will be subject to U.S. tax at the time the taxpayer abandons citizenship or residency.

Proposal

Existing rules would be expanded to provide that if a U.S. person expatriates on or after February 6, 1995, the person would be treated as having sold his or her assets at fair market value immediately prior to expatriation and gain or loss from such sale would be recognized and would be subject to U.S. income tax. A U.S. citizen would be considered to expatriate if the citizen renounces or abandons U.S. citizenship. A resident alien individual would be taxed under this proposal if the alien has been subject to U.S. tax as a lawful permanent resident of the United States in at least ten of the prior fifteen taxable years and then ceases to be subject to U.S. tax as a resident.

For this purpose, a taxpayer would be treated as owning those assets that would be included in the taxpayer's gross estate (determined as if the taxpayer's estate had been created on the date of expatriation) as well as, in certain cases, the taxpayer's interest in assets held in certain trusts (defined below in Section II of the foreign trust discussion). Exceptions to the tax on expatriation would be made for most U.S. real property interests (because they remain subject to U.S. taxing jurisdiction) and interests in qualified retirement plans. An expatriating individual also would be entitled to exclude $600,000 of gain as determined under the proposal.

The IRS may allow a taxpayer to defer payment of the tax on expatriation with respect to interests in closely-held businesses. In those cases, the taxpayer would be required

to provide collateral satisfactory to the IRS. Payment of tax could not be deferred for more than five years, and an interest charge would be imposed on the deferred tax.

Solely for purposes of determining gain or loss subject to the tax on expatriation, a resident alien individual would be permitted to elect to determine basis using the fair market value (instead of historical cost) of assets owned on the date when U.S. residence first began. If made, this election would apply to all of a taxpayer's property.

This proposal would replace existing income tax rules with respect to expatriations on or after February 6, 1995. Existing rules that apply to taxes other than income taxes would continue to apply.

Revenue Estimate (in billions of dollars)

	Fiscal Years						
	1995	1996	1997	1998	1999	2000	Total
Tax responsibilities of Americans who renounce citizenship	0.1	0.2	0.3	0.4	0.5	0.7	2.2

REVISE TAXATION OF INCOME FROM FOREIGN TRUSTS

U.S. tax rules applicable to foreign trusts have not been revised for nearly two decades. New rules are needed to accommodate changes in the use and incidence of foreign trusts and to limit the avoidance and evasion of U.S. taxes. The Administration proposals would reform the taxation of foreign trusts in five respects.

I. INFORMATION REPORTING AND FOREIGN TRUSTS

Current Law

Under current law, most foreign trusts established by U.S. persons are grantor trusts, the income of which is taxed to the grantor. U.S. persons who create or transfer property to foreign trusts are required to report transactions with the foreign trust to the IRS.

Reasons for Change

The existing information reporting statute predates the significant expansion of the foreign grantor trust rules in 1976. In general, penalties for noncompliance with reporting requirements are minimal. U.S. grantors of foreign trusts often do not report the income earned by foreign trusts and often do not comply with required information reporting. These foreign trusts are frequently established in tax haven jurisdictions with stringent secrecy rules. Consequently, the IRS's attempts to verify income earned by foreign trusts are often unsuccessful. Existing penalties have not proven adequate to encourage some U.S. taxpayers to comply with existing rules.

Proposal

Notice of Transfer. Section 6048 would require U.S. persons transferring property to foreign trusts to notify the IRS. This notice would identify the trustee of the foreign trust, indicate the property transferred to the trust, and identify the trust beneficiaries.

If a transferor did not file the required notice, a penalty would be imposed equal to 35 percent of the gross value of the property transferred, valued as of the date of transfer. This penalty would not be less than $10,000, and could be further increased for continuing noncompliance.

Trustee Statements. Section 6048 would require trustees of any foreign trust with a U.S. grantor or a U.S. beneficiary to file two types of statements: a "Section 6048 Statement" and an annual information return. In the Section 6048 Statement, the trustee would be required to:

1) appoint a U.S. agent (whether or not a trustee) who has the ability to provide any information that reasonably should be available to the trust in response to requests by the IRS; and

2) agree to file an annual information return for the foreign trust.

The annual information return would be required to include a full accounting of trust activities, including separate schedules (K-1s) for income attributable to U.S. grantors or U.S. beneficiaries, as appropriate. The foreign trust would not be considered to have an office or permanent establishment in the United States merely because of the section 6048 activities of its U.S. agent.

There would be two consequences if the trustee of the foreign trust did not file a Section 6048 Statement or the required annual information return. First, the U.S. settlor of a foreign trust would be subject to a $10,000 penalty for each failure to file a Section 6048 Statement or annual information return. This penalty would be increased for continuing noncompliance. Second, the IRS would be authorized to determine, in its discretion, the tax consequences of any trust transactions or operations to a U.S. grantor or U.S. beneficiary. Thus, for example, the IRS could impose a gift tax on property transferred to the foreign trust. In appropriate circumstances, the IRS could also impute taxable income to the U.S. settlor based on the value of assets transferred to or held in the foreign trust. A distribution to a U.S. beneficiary could be deemed to come from income accumulated in the year the trust was organized (or an alien beneficiary's first year of U.S. residence, if later). Although the trustee would have an incentive to file the trustee statements to avoid adverse U.S. tax consequences to U.S. grantors and U.S. beneficiaries, there would be no penalties directly imposed on a trustee for the failure to file those statements.

The Secretary would be authorized to waive any information reporting requirements when there was no significant U.S. tax interest in obtaining the information. Penalties would not be imposed if the taxpayer acted with reasonable cause and not willful neglect.

These proposals generally would be effective for trust taxable years beginning after the date of enactment.

II. OUTBOUND FOREIGN GRANTOR TRUSTS

Current Law

Under section 679, a foreign trust established by a U.S. person for the benefit of U.S. persons generally is a "grantor trust", and the grantor is treated as owner of property transferred to the trust. There are, however, some transfers that are not covered by this general rule. First, transfers by reason of death are not subject to section 679. Second, sales of property to a foreign trust at fair market value are not subject to section 679. Third, if a foreign person transfers property to a foreign trust for the benefit of a U.S. person and

then becomes a resident of the United States, section 679 does not apply to the transfer. Finally, current rules do not clearly address the tax consequences for a domestic trust that becomes a foreign trust.

Reasons for Change

Tax planning to avoid or defer recognition of income from foreign trusts often utilizes the exceptions to section 679. For example, a foreign trust may be established by will upon the death of a U.S. person for the benefit of U.S. persons. Because the trust is not a grantor trust, the income of the trust is not subject to U.S. tax until distributed to a U.S. person, even though the trust was created by a U.S. person for the benefit of a U.S. person.

U.S persons also sometimes attempt to avoid section 679 by selling property to a foreign trust in exchange for a note from the trust. Often, the U.S. transferor does not intend to collect on the note. In such a case, the purported seller of the assets should be treated as owning the assets transferred to the trust. (If there is no *bona fide* debt, these transactions are subject to challenge under current law, because the exchange would not be at fair market value.)

Prior to becoming residents of the United States, foreign persons often put their assets into irrevocable trusts in tax haven jurisdictions for the benefit of U.S. persons. As a result, the trust income escapes U.S. tax until distribution.

Further, as tax haven jurisdictions enact legislation to enable U.S. trusts to move to those jurisdictions, trust migrations are becoming more common. Taxpayers should not be able to achieve tax results through migration of a domestic trust that they could not achieve directly by creating a foreign trust.

Finally, the inadequacy of the existing attribution rules as they apply to discretionary beneficiaries encourages taxpayers to avoid the appropriate tax consequences of their transactions by disguising true economic ownership of assets through the use of foreign discretionary trusts.

Proposal

The Administration proposes several changes to section 679, described below.

Transfers at Death. Property transferred to a foreign trust at the death of a trust grantor (including property in a foreign grantor trust at the grantor's death) would be treated as having been transferred to the trust by the beneficiaries in accordance with their respective interests in the trust (described below) in a transaction in which no gain or loss would be recognized. U.S. beneficiaries therefore would become grantors for purposes of section 679. These proposals would be effective for assets transferred to foreign trusts after the date of enactment.

Sales to Foreign Trusts. The sale of property to a foreign trust by a U.S. person would be considered a transfer to a grantor trust under section 679 unless the trust pays the grantor full fair market value for the property without regard to any debt obligation received by the transferor issued by the trust, the grantor, a beneficiary, or a person related to the grantor or beneficiary or guaranteed by any such person. Exceptions would be provided for legitimate commercial transactions, such as credit extended by unrelated persons. A transferor would not be treated as receiving fair market value for property transferred in a deemed sale (pursuant to an election under section 1057 or otherwise). These proposals would be effective for assets transferred to foreign trusts on or after February 6, 1995.

Pre-immigration Trusts. If a foreign person transfers property to a foreign trust and becomes a U.S. person within five years of the transfer, the trust would be considered a grantor trust under section 679 with respect to such transferred assets if the trust has U.S. beneficiaries after the grantor becomes a U.S. person. This proposal would be effective for assets transferred to foreign trusts on or after February 6, 1995.

Outbound Trust Migrations. For purposes of section 679, if a domestic trust becomes a foreign trust, the trust assets would be deemed to have been transferred to the trust by the beneficiaries in accordance with their respective interests in the trust (defined below) in a transaction in which no gain or loss is recognized. Thus, any U.S. beneficiaries would be considered to be grantors of their respective interests in the foreign trust for purposes of section 679. However, if the IRS determines that the domestic trust was established pursuant to a plan to retransfer assets to a foreign trust, the IRS would be permitted to treat the U.S. settlor of the domestic trust as grantor of the foreign trust for purposes of section 679. The proposal would be effective for assets transferred to foreign trusts on or after February 6, 1995.

Determination of Respective Interests. For purposes of preventing abusive transactions designed to avoid section 679 and the tax on expatriation, a beneficiary's respective interest in a trust would be based on all relevant facts and circumstances, including the terms of the trust instrument. Other relevant factors may include letters of wishes or similar documents, patterns of historical trust distributions, and the existence of and functions performed by a trust protector or any similar advisor. If the respective interests of beneficiaries in a discretionary trust cannot otherwise be determined, those beneficiaries with the closest degree of family affiliation to the settlor could be presumed to have equal proportionate interests in the trust.

The proposal would apply the attribution rules for discretionary beneficiaries only to the abusive situations under section 679 described above and to the tax on expatriation of U.S. citizens and residents, but would not directly apply the attribution rules for other purposes (*e.g.*, to determine if a discretionary beneficiary is a U.S. shareholder of a controlled foreign corporation that is owned by the trust). The determination of respective interests for purposes of the tax on expatriation by U.S. citizens and residents would be effective for expatriations occurring on or after February 6, 1995.

III. INBOUND FOREIGN GRANTOR TRUSTS

Current Law

The United States disregards certain "grantor" trusts for income tax purposes. This treatment is designed to prevent abuses arising from attempts to shift income to beneficiaries who are likely to be paying taxes at lower rates than the grantor of the trust. Consequently, under existing anti-abuse rules, the grantor of such a trust is taxed as if he owned the trust assets directly. Trusts generally are considered grantor trusts if (1) the grantor has a reversionary interest in trust income or corpus, (2) the grantor or a nonadverse party holds certain powers over the beneficial enjoyment of trust income or corpus, (3) certain administrative powers are exercisable for the grantor's benefit (*e.g.*, the grantor can reacquire trust assets by substituting assets of equivalent value), (4) the grantor or a nonadverse party has the power to revest trust assets in the grantor, or (5) trust income may be paid or accumulated for the benefit of the grantor or the grantor's spouse in the discretion of the grantor or a nonadverse party. A person other than the grantor is treated as owning trust assets if that person has the power to withdraw trust income or corpus.

The IRS has issued a revenue ruling in which a foreign person funded a foreign grantor trust for U.S. beneficiaries. The ruling holds that since the foreign person is treated as the owner of the grantor trust, a U.S. beneficiary is not taxable on trust distributions.

Reasons for Change

Existing law inappropriately permits foreign taxpayers to affirmatively use the domestic anti-abuse rules concerning grantor trusts. Although current law treats a foreign grantor as the owner of the trust assets, the foreign grantor generally is not subject to U.S. tax on income of the trust. These rules therefore permit U.S. beneficiaries, who enjoy the benefits of residing in the United States, to avoid U.S. tax on trust income. U.S. beneficiaries should be appropriately taxed in the United States.

Proposal

Under the proposal, a person would be treated as owning trust assets under the grantor trust rules only if that person is a U.S. citizen, U.S. resident, or domestic corporation. The IRS may prescribe rules for applying the grantor trust rules to settlors that are partnerships, trusts, and estates to the extent that the beneficial interests in such entities are owned by U.S. citizens, U.S. residents, or domestic corporations. A U.S. person receiving distributions of trust income as result of this provision would be allowed to claim a foreign tax credit for foreign taxes paid on trust income by the trust or the foreign grantor.

Several related provisions are proposed to enforce these rules. First, enhanced authority would be granted to the IRS to prevent the use of nominees to evade these rules. For this purpose, a *bona fide* settlor of a trust with power to withdraw income or corpus from the trust would normally not be considered a nominee. Second, new rules would

harmonize the treatment of purported gifts by corporations and partnerships with the new foreign grantor trust rules. Third, U.S. persons would be required to report the receipt of what they claim to be large gifts from foreign persons in order to allow the IRS to verify that such purported gifts are not, in fact, disguised income to the U.S. recipients.

If a trust that is a grantor trust under current law becomes a nongrantor trust pursuant to this rule, the trust would be treated as if it were resettled on the date the trust becomes a nongrantor trust. Neither the grantor nor the trust would recognize gain or loss. If a resettled domestic trust that has a foreign grantor became a foreign trust before December 31, 1995, the section 1491 excise tax on outbound transfers of assets would not be applied to the transfer by the domestic trust to the new foreign trust. Otherwise, this proposal would be effective on the date of enactment of this provision. These rules would not apply to normal security arrangements involving a trustee (including the use of indenture trustees and similar arrangements).

IV. FOREIGN NONGRANTOR TRUSTS

Current Law

Accumulation distributions. U.S. beneficiaries of foreign trusts are subject to a nondeductible interest charge on distributions of accumulated income earned by the trust in earlier taxable years. The charge is based on the length of time the tax was deferred by deferring distributions of accumulated income. Under existing law, the interest charge is equal to six percent simple interest per year multiplied by the tax imposed on the distribution. If adequate records are not available to determine the portion of a distribution that is accumulated income, the distribution is deemed to be an accumulation distribution from the year the trust was organized.

Constructive Distributions. The tax consequences of the use of trust assets by beneficiaries is ambiguous under current law. Taxpayers may assert that a beneficiary's use of assets owned by a trust does not constitute a distribution to the beneficiary.

Reasons for Change

Accumulation distributions. Interest paid by U.S. beneficiaries of foreign trusts should reflect market rates of interest.

Constructive distributions. If a corporation makes corporate assets available for a shareholder's personal use (*e.g.*, a corporate apartment made available rent-free to a shareholder), the fair market value of the use of that property is treated as a constructive distribution. Further, if a controlled foreign corporation makes a loan to a U.S. person, the loan is treated as a deemed distribution by the foreign corporation to its U.S. shareholders. The use of foreign trust assets by trust beneficiaries should give rise to tax consequences that are similar to those associated with the use of corporate assets by corporate shareholders.

Proposal

Accumulation distributions. For periods of accumulation after December 31, 1995, the rate of interest charged on accumulation distributions would correspond to the interest rate taxpayers pay on underpayments of tax. If a trust does not provide information required under section 6048, the distribution would be deemed to be from income accumulated in the year the trust was organized (or an alien beneficiary's first year of U.S. residence, if later). If a taxpayer is not able to demonstrate when the trust was created, the IRS may use any approximation based on available evidence.

Taxpayers have used a variety of methods (*e.g.*, tiered trusts, divisions of trusts, mergers of trusts, and similar transactions with corporations) to convert a distribution of accumulated income into a distribution of current income or corpus. The proposal would authorize the IRS to recharacterize such transactions, effective for transactions or arrangements entered into after the date of enactment. Transactions that may be entered into to avoid the interest charge on accumulation distributions (*e.g.*, excessive "compensation" paid to trust beneficiaries who are directors of corporations owned by the foreign trust) may be subject to recharacterization.

The proposal also clarifies existing law by providing that if an alien beneficiary of a foreign trust becomes a U.S. resident and thereafter receives an accumulation distribution, no interest would be charged for periods of accumulation that predate U.S. residency.

Constructive distributions. If a beneficiary uses assets of a foreign trust, the value of that use would be a constructive distribution to the beneficiary. Thus, if a foreign trust made a residence available for use by a beneficiary (or a related person), the difference between the fair rental value of the residence and any rent actually paid would be treated as a constructive distribution to that beneficiary. If a foreign trust purported to loan cash (or cash equivalents) to a U.S. beneficiary, the loan would be treated as a constructive distribution by the foreign trust to the U.S. beneficiary. These provisions would not apply if constructive distributions did not exceed $2,500 during a taxable year. The provisions would be effective for taxable years of a trust that begin after the date of enactment.

V. RESIDENCE OF TRUSTS

Current Law

Under current law, a "foreign estate or trust" is an estate or trust the "income of which, from sources without the United States which is not effectively connected with the conduct of a trade or business within the United States, is not includable in gross income under subtitle A" of the Internal Revenue Code. This definition does not provide criteria for determining when an estate or trust is foreign.

Court cases and rulings indicate that the residence of an estate or trust depends on various factors, such as the location of the assets, the country under whose laws the estate or

trust is created, the residence of the fiduciary, the nationality of the decedent or settlor, the nationality of the beneficiaries, and the location of the administration of the trust or estate. *See e.g.*, *B.W. Jones Trust v. Comm'r*, 46 B.T.A. 531 (1942), *aff'd*, 132 F.2d 914 (4th Cir. 1943).

Reasons for Change

Present rules provide insufficient guidance for determining the residence of estates and trusts. Because the tax treatment of an estate, trust, settlor, or beneficiary may depend on whether the estate or trust is foreign or domestic, it is important to have an objective definition of the residence of an estate or trust. Reducing the number of factors used in determining the residence of estates or trusts for tax purposes would increase the flexibility of settlors and trust administrators to decide where to locate and in what assets to invest. For example, if the location of the administration of the trust were no longer a relevant criterion, settlors of foreign trusts would be able to choose whether to administer the trusts in the United States or abroad based on non-tax considerations.

Proposal

An estate or trust would be considered a domestic estate or trust if two factors were present: (1) a court within the United States is able to exercise primary supervision over the administration of the estate or trust; and (2) a U.S. fiduciary (alone or in concert with other U.S. fiduciaries) has the authority to control all major decisions of the estate or trust. A foreign estate or trust would be any estate or trust that is not domestic.

The first factor would be fulfilled only if a U.S. court had authority over the entire estate or trust, and not if it merely had jurisdiction over certain assets or a particular beneficiary. Normally, the first factor would be satisfied if the trust instrument is governed by the laws of a U.S. state. One way to satisfy this factor is to register the estate or trust in a state pursuant to a state law which is substantially similar to Article VII of the Uniform Probate Code as published by the American Law Institute. The second factor would normally be satisfied if a majority of the fiduciaries are U.S. persons and a foreign fiduciary (including a "protector" or similar trust advisor) may not veto important decisions of the U.S. fiduciaries. In applying this factor, the IRS would allow an estate or trust a reasonable period of time to adjust for inadvertent changes in fiduciaries (*e.g.*, a U.S. trustee dies or abruptly resigns where a trust has two U.S. fiduciaries and one foreign fiduciary).

The new rules defining domestic estates and trusts would be effective for taxable years of an estate or trust that begin after December 31, 1996. The delayed effective date is intended to allow estates and trusts a period of time to modify their governing instruments or to change fiduciaries. Moreover, taxpayers would be allowed to elect to apply these rules to taxable years of an estate or trust beginning after the date of enactment.

Revenue Estimate (in billions of dollars)

	Fiscal Years						
	1995	1996	1997	1998	1999	2000	Total
Revise taxation of income from foreign trusts (sections I - V)	0.1	0.3	0.5	0.5	0.5	0.6	2.4

PROPOSALS TO IMPROVE TAX ADMINISTRATION AND COMPLIANCE

The Administration continues to support revenue-neutral initiatives to promote sensible and equitable administration of the internal revenue laws. These include simplification, technical corrections, and taxpayer compliance measures, including the reinstatement of authority to share information on cash transaction reports within the law enforcement community and to fund undercover operations. In addition, we support and want to work with Congress on the following proposals:

- intermediate sanctions and disclosure requirements to improve public charities' compliance with the requirements for tax-exempt status;

- a package of compliance and administrative initiatives that would assist the IRS's efforts to modernize and streamline its operations, to alleviate taxpayer burdens by facilitating the payment of taxes and filing of tax returns, and to rationalize existing rules to treat taxpayers more fairly; and

- modifications to improve compliance with diesel dyeing requirements and to facilitate refunds of the excise tax on the sale of certain fuels.

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