WAYS AND MEANS COMMITTEE MARKUP OF ADMINISTRATION'S REVENUE PROPOSALS

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of the

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the Administration's revenue proposals included in President Clinton's fiscal year 1994 budget proposal.[2] The House Ways and Means Committee is scheduled to mark up revenue reconciliation provisions under the Budget Resolution for fiscal year 1994.

Part I describes the revenue-raising provisions and Part II describes the revenue-reduction provisions. (A separate staff document presents the estimated budget effects of the Administration's revenue proposals.)

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[1] This document may be cited as follows: Joint Committee on Taxation, Ways and Means Committee Markup of the Administration's Revenue Proposals (JCX-1-93), May 4, 1993.

[2] See Department of the Treasury, Summary of the Administration's Revenue Proposals, February 1993; supplemented by "Description of Modified BTU Tax," April 1, 1993, and "Supplement to Summary of the Administration's Revenue Proposals," April 1993. Also, see Office of Management and Budget, A Vision of Change for America, February 17, 1993, and Budget of the United States Government, Fiscal Year 1994. Further, see Joint Committee on Taxation, Summary of the President's Revenue Proposals (JCS-4-93), March 8, 1993.

I. REVENUE-RAISING PROVISIONS

A. Individual Income and Estate and Gift Tax Provisions

1. Increased tax rates for higher income individuals

Present Law

Regular tax rates

For 1993, the individual income tax rates are as follows--

If taxable income is:	Then income tax equals:
Single individuals	
$0-$22,100	15 percent of taxable income.
$22,100-$53,500	$3,315.00 plus 28% of the amount over $22,100.
Over $53,500	$12,107.00 plus 31% of the amount over $53,500.
Heads of household	
$0-$29,600	15 percent of taxable income.
$29,600-$76,400	$4,440.00 plus 28% of the amount over $29,600.
Over $76,400	$17,544.00 plus 31% of the amount over $76,400.
Married individuals filing joint returns	
$0-$36,900	15 percent of taxable income.
$36,900-$89,150	$5,535 plus 28% of the amount over $36,900.
Over $89,150	$20,165 plus 31% of the amount over $89,150.
Married individuals filing separate returns	
$0-$18,450	15 percent of taxable income.
$18,450-$44,575	$2,767.50 plus 28% of the amount over $18,450.
Over $44,575	$10,082.50 plus 31% of the amount over $44,575.
Estates and trusts	
$0-$3,750	15 percent of taxable income.
$3,750-$11,250	$562.50 plus 28% of the amount over $3,750.
Over $11,250	$2,662.50 plus 31% of the amount over $11,250.

The individual income tax brackets are indexed for inflation.

Alternative minimum tax

An individual taxpayer is subject to an alternative minimum tax (AMT) to the extent that the taxpayer's tentative minimum tax exceeds the taxpayer's regular tax liability. A taxpayer's tentative minimum tax generally equals 24 percent of alternative

minimum taxable income (AMTI) in excess of an exemption amount. The exemption amount is $40,000 for married taxpayers filing joint returns and $30,000 for single taxpayers and head of household filers. The exemption amount is phased out for taxpayers with AMTI above $150,000 for married taxpayers filing joint returns and $112,500 for single taxpayers and head of household filers.

Surtax on higher-income taxpayers

Under present law, there is no surtax imposed on higher-income individuals.

Itemized deduction limitation

Under present law, individuals who do not elect the standard deduction may claim itemized deductions (subject to certain limitations) for certain nonbusiness expenses incurred during the taxable year. Among these deductible expenses are unreimbursed medical expenses, unreimbursed casualty and theft losses, charitable contributions, qualified residence interest, State and local income and property taxes, unreimbursed employee business expenses, and certain other miscellaneous expenses.

Certain itemized deductions are allowed only to the extent that the amount exceeds a specified percentage of the taxpayer's adjusted gross income (AGI). Unreimbursed medical expenses for care of the taxpayer and the taxpayer's spouse and dependents are deductible only to the extent that the total of these expenses exceeds 7.5 percent of the taxpayer's AGI. Nonbusiness, unreimbursed casualty or theft losses are deductible only to the extent that the amount of loss arising from each casualty or theft exceeds $100 and only to the extent that the net amount of casualty and theft losses exceeds 10 percent of the taxpayer's AGI. Unreimbursed employee business expenses and certain other miscellaneous expenses are deductible only to the extent that the total of these expenses exceeds 2 percent of the taxpayer's AGI.

The total amount of otherwise allowable itemized deductions (other than medical expenses, casualty and theft losses, and investment interest) is reduced by 3 percent of the amount of the taxpayer's AGI in excess of $108,450 in 1993 (indexed for inflation). Under this provision, otherwise allowable itemized deductions may not be reduced by more than 80 percent. In computing the reduction of total itemized deductions, all present-law limitations applicable to such deductions are first applied and then the otherwise allowable total amount of deductions is reduced in accordance with this provision.

The reduction of otherwise allowable itemized deductions does not apply to taxable year beginning after December 31, 1995.

Personal exemption phaseout

Present law permits a personal exemption deduction from gross

income for an individual, the individual's spouse, and each dependent. For 1993, the amount of this deduction is $2,350 for each exemption claimed. This exemption amount is adjusted for inflation. The deduction for personal exemptions is phased out for taxpayers with AGI above a threshold amount (indexed for inflation) which is based on filing status. For 1993, the threshold amounts are $162,700 for married taxpayers filing joint returns, $81,350 for married taxpayers filing separate returns, $135,600 for unmarried taxpayers filing as head of household, and $108,450 for unmarried taxpayers filing as single.

The total amount of exemptions that may be claimed by a taxpayer is reduced by 2 percent for each $2,500 (or portion thereof) by which the taxpayer's AGI exceeds the applicable threshold (the phaseout rate is 4 percent for married taxpayers filing separate returns). Thus, the personal exemptions claimed are phased out over a $122,500 range, beginning at the applicable threshold.

This provision does not apply to taxable years beginning after December 31, 1996.

Administration's Proposal

New marginal tax rates

The proposal would impose a new 36-percent marginal tax rate to taxable income in excess of the following thresholds:

Filing status	Applicable threshold
Married individuals filing joint returns	$140,000
Heads of households	$127,500
Unmarried individuals	$115,000
Married individuals filing separate returns	$ 70,000
Estates and trusts	$ 5,500

For estates and trusts, the 15-percent rate would apply to income up to $1,500, the 28-percent rate would apply to income between $1,500 and $3,500, and the 31-percent rate would apply to income between $3,500 and $5,500. Under this modified tax rate schedule for estates and trusts, the benefits of the rates below the 39.6-percent surtax-included rate (described below) for 1993 would approximate the benefits of the 15- and 28-percent rates for 1993 under present law.

As under present law, the tax rate bracket thresholds (including the thresholds for the new 36-percent rate) would be indexed for inflation.

Alternative minimum tax

The proposal would provide a two-tiered graduated rate schedule for the AMT for taxpayers other than corporations. A 26-percent rate would apply to the first $175,000 of a taxpayer's AMTI in excess of the exemption amount, and a 28-percent rate would apply to AMTI more than $175,000 above the exemption amount. For married individuals filing separate returns, the 28-percent rate would apply to AMTI more than $87,500 above the exemption amount. The proposal would increase the exemption amount to $45,000 for married individuals filing joint returns, to $33,750 for unmarried individuals, and to $22,500 for married individuals filing separate returns, estates and trusts.

Surtax on higher-income taxpayers

The proposal would provide a 10-percent surtax on individuals with taxable income in excess of $250,000 and on estates and trusts with taxable income in excess of $7,500. For married taxpayers filing separate returns, the threshold amount for the surtax would be $125,000. The surtax would be computed by applying a 39.6-percent rate to taxable income in excess of the applicable threshold. Under this method of computation, unlike a simple 10-percent increase in tax liability, capital gains would not be subject to tax at a rate in excess of the current 28-percent maximum rate. The threshold for the surtax would be indexed for inflation in the same manner as other individual income tax rate thresholds.

Itemized deduction limitation and phaseout of personal exemptions

The proposal would make permanent the provisions that limit itemized deductions and phase out personal exemptions.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1993. Withholding tables for 1993 would not be revised to reflect the changes in tax rates. Penalties for the underpayment of estimated taxes, however, would be waived for underpayments of 1993 taxes attributable to these changes in tax rates.

2. Provisions to prevent conversion of ordinary income to capital gain

a. Treatment of net capital gains as investment income

Present Law

In the case of a taxpayer other than a corporation, deductions for interest on indebtedness that is allocable to property held for investment ("investment interest") are limited to the taxpayer's net investment income for the taxable year. Disallowed investment interest is carried forward to the next taxable year. Investment income includes gross income (other than gain on disposition) from property held for investment and any net gain attributable to the disposition of property held for investment.

Investment interest that is allowable is deductible at ordinary rates. The net capital gain (i.e., net long-term capital gain less net short-term capital loss) of a noncorporate taxpayer is taxed at a maximum rate of 28 percent.

Prior to 1986, long-term capital gains were not included in investment income for purposes of computing the investment interest limitation.

Administration's Proposal

Under the proposal, net capital gain generally would not be included in investment income for purposes of computing the investment interest limitation. A taxpayer, however, could include net capital gain in investment income to the extent that the taxpayer elects to reduce his net capital gain eligible for the 28-percent maximum capital gains rate.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1992.

b. Definition of "substantially appreciated" inventory

Present Law

Under present law, amounts received by a partner in exchange for his interest in a partnership are treated as ordinary income to the extent they are attributable to substantially appreciated inventory of the partnership. For these purposes, inventory is treated as substantially appreciated if the value of the partnership's inventory exceeds both 120 percent of its adjusted basis and 10 percent of the value of all partnership property (other than money).

Administration's Proposal

The proposal would eliminate the requirement that the partnership's inventory exceed 10 percent of the value of all partnership property in order to be substantially appreciated. Thus, if the inventory is worth more than 120 percent of its adjusted basis, the inventory would be treated as substantially appreciated. In addition, any inventory property acquired with a principal purpose to reduce the appreciation to less than 120 percent in order to avoid ordinary income treatment would be disregarded in applying the 120-percent test.

Effective Date

The proposal would apply to exchanges of partnership interests after April 30, 1993.

c. Repeal of certain exceptions to the market discount rules

Present Law

A market discount bond is a bond that is acquired for a price that is less than the principal amount of the bond (or less than the amount of the issue price plus accrued original issue discount (OID) in the case of an OID bond). Market discount generally arises when the value of a debt obligation declines after issuance (typically, because of an increase in prevailing interest rates or a decline in the credit-worthiness of the borrower).

Gain on the disposition of a market discount bond generally must be recognized as ordinary income to the extent of the market discount that has accrued. This ordinary income rule, however, does not apply to tax-exempt obligations and to market discount bonds issued on or before July 18, 1984.

Administration's Proposal

Under the proposal, the ordinary income rule would apply to tax-exempt obligations and to market discount bonds issued on or before July 18, 1984, if the obligations are acquired after April 30, 1993. Thus, gain on the disposition of a tax-exempt obligation (or any other market discount bond) that is acquired for a price that is less than the principal amount of the bond generally would be treated as ordinary income (and not as tax-exempt interest or capital gain) to the extent of accrued market discount.

Effective Date

The proposal would be effective for bonds purchased on or after April 30, 1993. Thus, current owners of tax-exempt bonds and other market discount bonds issued on or before July 18,

1984, would not be required to treat accrued market discount as ordinary income.

d. Accrual of income by holders of stripped preferred stock

Present Law

In general, if a bond is issued at a price approximately equal to its redemption price at maturity, the expected return to the holder of the bond is in the form of periodic interest payments. In the case of original issue discount ("OID") bonds, however, the issue price is below the redemption price, and the holder receives his expected return in the form of price appreciation. The difference between the issue price and redemption price is the OID, and a portion of the OID is required to be accrued and included in the income of the holder annually. Similarly, for preferred stock that is issued at a discount from its redemption price, a portion of the redemption premium must be included in income annually.

A stripped bond (i.e., a bond issued with interest coupons that is later stripped of any of its unpaid interest coupons so that the ownership of the bond is separated from the ownership of the interest coupons) generally is treated as a bond issued with OID equal to (1) the stated redemption price of the bond at maturity minus (2) the amount paid for the stripped bond.

If preferred stock is stripped of some of its dividend rights, however, the stripped stock is not subject to the rules that apply to stripped bonds or to the rules that apply to bonds and preferred stock issued at a discount.

Administration's Proposal

The proposal would treat the purchaser of stripped preferred stock (and a person who strips preferred stock and disposes of the stripped dividend rights) in generally the same way that the purchaser of a stripped bond would be treated under the OID rules. Thus, stripped stock would be treated like a bond issued with OID equal to (1) the stated redemption price of the stock minus (2) the amount paid for the stock. The "OID" accrued under the proposal would be treated as ordinary income and not as interest or dividends.

Stripped preferred stock would be defined as any preferred stock where the ownership of the stock has been separated from the right to receive any dividend that has not yet become payable. The proposal would apply to stock that is limited and preferred as to dividends, does not participate in corporate growth to any significant extent, and has a fixed redemption price.

No inference would be intended as to the proper tax treatment of stripped preferred stock or stripped dividend rights under present law.

Effective Date

The proposal is effective for stripped stock that is purchased after April 30, 1993.

e. Recharacterization of capital gain as ordinary income for certain financial transactions

Present Law

Interest from a loan generally is treated as ordinary income. Gain from the sale or exchange of a capital asset generally is treated as capital gain.

Net capital gain (i.e., net long-term capital gain less net short-term capital loss) of an individual is subject to a maximum tax rate of 28 percent.

Financial transactions can be designed to generate income from the sale of capital assets with no economic risks other than the risks of default and of changing interest rates that all lenders bear. These financial transactions are functionally equivalent to loans, and the income is functionally equivalent to interest.

Administration's Proposal

The proposal would treat capital gain from certain transactions that are functionally equivalent to loans as ordinary income.[1] The proposal would apply only to gain that otherwise would be properly treated as capital gain under present law. No inference would be intended as to when gain is properly treated as capital gain under present law.

Under the proposal, capital gain from the disposition of property that was part of a "conversion transaction" would be recharacterized as ordinary income. The term "conversion transaction" would include transactions where substantially all of the taxpayer's expected net return was attributable to the time value of the taxpayer's net investment and where the taxpayer had (1) bought property and, at about the same time, agreed to sell the same or substantially identical property for a higher price in the future, (2) created a straddle of actively

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[1] This ordinary income would continue to be treated as gain from the sale of property for purposes such as the unrelated business income tax for tax-exempt organizations and the gross income requirement for regulated investment companies.

traded personal property, (3) entered into a transaction that was marketed or sold as producing capital gains, or (4) entered into a conversion transaction described in Treasury regulations.

The amount of gain from a disposition that would be recharacterized as ordinary income is calculated by applying an interest rate to the taxpayer's net investment in the conversion transaction (for a period that begins with the entering of the conversion transaction and ends with the disposition of the property (or, if earlier, the termination of the conversion transaction)).

For example, suppose a taxpayer buys 100 shares of X stock for $1,000 and, at the same time, enters into a contract to sell that stock in one year for $1,060. If the taxpayer sells the stock, and the gain would otherwise be treated as capital gain under present law, then a portion of the $60 gain would be recharacterized as ordinary income. That portion would be calculated by applying an interest rate of 120 percent of the Federal short-term rate to $1,000 for one year. If the calculated amount exceeds $60, all $60 of the taxpayer's gain would be recharacterized as ordinary income.

Effective Date

The proposal would be effective for conversion transactions entered into after April 30, 1993.

3. Repeal health insurance wage base cap

Present Law

As part of the Federal Insurance Contributions Act (FICA), a tax is imposed on employees and employers up to a maximum amount of employee wages. The tax is comprised of two parts: old-age, survivor, and disability insurance (OASDI) and Medicare hospital insurance (HI). For wages paid in 1993 to covered employees, the HI tax rate is 1.45 percent on both the employer and the employee on the first $135,000 of wages and the OASDI tax rate is 6.2 percent on both the employer and the employee on the first $57,600 of wages.

Under the Self-Employment Contributions Act of 1954 (SECA), a tax is imposed on an individual's self-employment income. The self-employment tax rate is the same as the total rate for employers and employees (i.e., 2.9 percent for HI and 12.40 percent for OASDI). For 1993, the HI tax is applied to the first $135,000 of self-employment income and the OASDI tax is applied to the first $57,600 self-employment income. In general, the tax is reduced to the extent that the individual had wages for which employment taxes were withheld during the year.

The cap on wages and self-employment income subject to FICA and SECA taxes is indexed to changes in the average wages in the economy.

Administration's Proposal

The proposal would eliminate the dollar limit on wages and self-employment income subject to HI taxes.

Effective Date

The proposal would be effective for wages and income received after December 31, 1993.

4. Reinstate top estate and gift tax rates at 53 percent and 55 percent

Present Law

A Federal gift tax is imposed on transfers by gift during life and a Federal estate tax is imposed on transfers at death. The Federal estate and gift taxes are unified, so that a single progressive rate schedule is applied to an individual's cumulative gifts and bequests. For decedents dying (or gifts made) after 1992, the estate and gift tax rates begin at 18 percent on the first $10,000 of taxable transfers and reach a maximum of 50 percent on taxable transfers over $2.5 million. Previously, for the nine year period beginning after 1983 and ending before 1993, two additional brackets applied at the top of the rate schedule, a rate of 53 percent on taxable transfers exceeding $2.5 million and a maximum marginal tax rate of 55 percent on taxable transfers exceeding $3 million. The generation-skipping transfer tax is computed by reference to the maximum Federal estate tax rate.

In order to phase out the benefit of the graduated brackets and unified credit, the estate and gift tax is increased by five percent on cumulative taxable transfers between $10 million and $18,340,000, for decedents dying and gifts made after 1992. (Prior to 1993, this phase out of the graduated rates and unified credit applied to cumulative taxable transfers between $10 million and $21,040,000.)

Administration's Proposal

The top two estate and gift tax rates which expired at the end of 1992 would be reinstated. For taxable transfers over $2.5 million but not over $3.0 million, the tax rate would be 53 percent. For taxable transfers over $3.0 million, the tax rate would be 55 percent. The phase out of the graduated rates and unified credit would be between $10 million and $21,040,000. Also, the rate of tax on generation-skipping transfers would be 55 percent.

Effective Date

The proposal would be effective for decedents dying, gifts made, and generation skipping transfers occurring after December 31, 1992.

5. Reduce deductible portion of business meals and entertainment expenses to 50 percent

Present Law

In general, a taxpayer is permitted a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business and, in the case of an individual, for the production of income. No deduction generally is allowed for personal, living, or family expenses.

Meal and entertainment expenses incurred for business or investment reasons are deductible if certain legal and substantiation requirements are met. The amount of the deduction generally is limited to 80 percent of the expense that meets these requirements. No deduction is allowed, however, for meal or beverage expenses that are lavish or extravagant under the circumstances.

Administration's Proposal

The proposal would reduce the deductible portion of otherwise allowable business meals and entertainment expenses from 80 percent to 50 percent.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1993.

6. Deny deduction for club dues

Present Law

No deduction is permitted for club dues unless the taxpayer establishes that his or her use of the club was primarily for the furtherance of the taxpayer's trade or business and the specific expense was directly related to the active conduct of that trade or business (Code sec. 274(a)). No deduction is permitted for an initiation or similar fee that is payable only upon joining a club if the useful life of the fee extends over more than one year. Such initial fees are nondeductible capital expenditures.[1]

Administration's Proposal

Under the proposal, no deduction would be permitted for club dues. This rule would apply to all types of clubs (other than those exempted below), including business, social, athletic, luncheon, and sporting clubs. Specific business expenses (e.g., meals) incurred at a club would be deductible only to the extent they otherwise satisfy the standards for deductiblity.

Dues for airline and hotel clubs would not be subject to the proposal.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1993.

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[1] *Kenneth D. Smith*, 24 TCM 899 (1965).

7. Deny deduction for executive pay over $1 million

Present Law

The gross income of an employee includes any compensation received for services rendered. An employer is allowed a corresponding deduction for reasonable salaries and other compensation. Whether compensation is reasonable is determined on a case-by-case basis. However, the reasonableness standard has been used primarily to limit payments by closely-held companies where dividends may be disguised as deductible compensation.

Administration's Proposal

The proposal would preclude any publicly-held corporation from taking a deduction for compensation in excess of $1 million for any one of its top five executives. For this purpose, a corporation would be treated as publicly held if the corporation's common equity securities are registered under section 12 of the Securities Exchange Act of 1934. The corporation's top five executives would be defined as under the SEC rules governing disclosure of executive compensation (i.e., the chief executive officer and the four other most highly-compensated officers of the corporation).

Certain types of compensation would not be subject to the deduction limit and would not be taken into account in determining whether other compensation exceeds $1 million. The following compensation would not be taken into account: (1) payments to a tax-qualified retirement plan (including salary reduction contributions), (2) amounts that are excludable from the executive's gross income, and (3) qualified performance-based compensation. Qualified performance-based compensation would include any compensation that is payable on a commission basis and any performance-based compensation that meets certain independent director and shareholder approval requirements. The $1 million cap would be reduced by excess parachute payments that are not deductible to the corporation.

Commissions would be defined as compensation paid solely on account of income generated directly by the individual performance of the executive. Thus, for example, compensation that equals a percentage of sales made by the executive or a percentage of business that is directly attributable to the executive would be treated as a commission. Income would not fail to be attributable directly to the executive merely because in generating the income the executive utilizes the support services of other employees, such as secretarial or research services. However, where compensation is paid on account of broader performance standards, such as income produced by a business unit, the compensation would be not a commission because it would not be paid with regard to income that is directly attributable to the individual executive.

Qualified performance-based compensation also would include any compensation, other than commissions, that is paid solely on account of the attainment of one or more performance goals, provided that: (1) the performance goals are established by a compensation committee consisting solely of two or more independent directors; (2) the material terms under which the compensation is to be paid, including the performance goals, are disclosed to and approved by the shareholders in a separate vote prior to payment; and (3) prior to payment, the compensation committee certifies that the performance goals and any other material terms were in fact satisfied by the executive. Compensation would not be treated as qualified performance-based compensation if the executive has a right to receive the compensation notwithstanding the failure of the compensation committee to certify attainment of the performance goal or the absence of shareholder approval. Under the proposal, a performance goal would be defined broadly to include any performance standard that is applied to the individual executive, a business unit, or the corporation as a whole. For example, stock options or other stock appreciation rights generally would be treated as qualified performance-based compensation, provided that the requirements for independent director and shareholder approval are met, because the amount of compensation paid to the executive is based on an increase in the corporation's stock price.

Effective Date

The proposal would generally apply to compensation that is otherwise deductible to the corporation in a taxable year beginning on or after January 1, 1994. However, the proposal would not apply to compensation paid under a binding written plan or agreement in effect on February 17, 1993, and at all times thereafter. This grandfather rule would not apply to the extent that significant relevant aspects of the plan or agreement are modified after February 17, 1993. For example, compensation that is deductible on account of stock options or restricted stock rights granted on or before February 17, 1993, would continue to be deductible without regard to the $1 million limit.

8. Reduce compensation taken into account for qualified retirement plan purposes

Present Law

A limit is provided with respect to the amount of a participant's compensation that can be taken into account under a tax-qualified pension plan (sec. 401(a)(17)). This limit on includible compensation is $235,840 for 1993, and is adjusted annually for inflation. The limit applies for determining the amount of the employer's deduction for contributions to the plan as well as for determining the amount of the participant's benefits.

Administration's Proposal

Under the proposal, the section 401(a)(17) limit would be reduced to $150,000. As under present law, the section 401(a)(17) limit would be indexed for cost-of-living adjustments on an annual basis. Corresponding changes also would be made to other provisions that take into account the section 401(a)(17) limit.

Effective Date

The proposal would be effective for plan years beginning after December 31, 1993. Benefits accrued prior to the effective date for compensation in excess of the reduced limit would be grandfathered.

9. Deduction for moving expenses

Present law

An employee or self-employed individual may claim a deduction from gross income for certain expenses incurred as a result of moving to a new residence in connection with beginning work at a new location (sec. 217). The deduction is not subject to the floor that generally limits a taxpayer's allowable miscellaneous itemized deductions to those amounts that exceed 2 percent of his adjusted gross income. Any amount received directly or indirectly by such individual as a reimbursement of moving expenses must be included in the taxpayer's gross income as compensation (sec. 82). The taxpayer may offset this income by deducting the moving expenses that would otherwise qualify as deductible items under section 217.

Deductible moving expenses are the expenses of transporting the taxpayer and members of his household, as well as his household goods and personal effects, from the old residence to the new residence; the cost of meals and lodging enroute; the expenses for pre-move househunting trips; temporary living expenses for up to 30 days in the general location of the new job; and certain expenses related to either the sale or settlement of a lease on the old residence or the purchase of or the acquisition of a lease on a new residence in the general location of the new job.

The moving expense deduction is subject to a number of limitations. A maximum of $1,500 can be deducted for pre-move househunting and temporary living expenses in the general location of the new job. A maximum of $3,000 (reduced by any deduction claimed for househunting or temporary living expenses) can be deducted for certain qualified expenses for the sale or purchase of a residence or settlement or acquisition of a lease. If both a husband and wife begin new jobs in the same general location, the move is treated as a single commencement of work. If a husband and wife file separate returns, the maximum deductible amounts available to each are one-half the amounts otherwise allowed.

Also, in order for a taxpayer to claim a moving expense deduction, his new principal place of work has to be at least 35 miles farther from his former residence than was his former principal place of work (or at least 35 miles his former residence, if he has no former place of work).

Administration's Proposal

The proposal would exclude from the definition of moving expenses: (1) the costs of meals consumed while traveling and while living in temporary quarters near the new workplace, and (2) the costs of selling (or settling an unexpired lease on) the old residence and buying (or acquiring a lease on) the new residence.

Effective Date

The proposal would be effective for expenses incurred after December 31, 1993.

10. Increase taxable portion of Social Security and Railroad Retirement Tier 1 benefits

Present Law

Under present law, a portion of Social Security and Railroad Retirement Tier 1 benefits are includible in gross income for taxpayers whose incomes exceed a threshold amount. For purposes of this computation, a taxpayer's income includes modified adjusted gross income (adjusted gross income plus tax-exempt interest) plus one-half of the individual's Social Security or Railroad Retirement Tier 1 benefit. The threshold amount is $32,000 for married taxpayers filing joint returns, $25,000 for unmarried taxpayers, and $0 for married taxpayers filing separate returns. An individual is required to include in gross income the lesser of: (1) 50 percent of the individual's Social Security or Railroad Retirement Tier 1 benefit, or (2) 50 percent of the excess of the taxpayer's income over the applicable threshold amount.

Proceeds from the income taxation of these benefits are credited quarterly to the Old-Age and Survivors Insurance Trust Fund, the Disability Insurance Trust Fund, or the Social Security Equivalent Benefit Account (of the Railroad Retirement system), as appropriate.

Administration's Proposal

The proposal would require that individuals include in gross income the lesser of: (1) 85 percent of the individual's Social Security or Railroad Retirement Tier 1 benefit, or (2) 85 percent of the excess of the taxpayer's income over the applicable present law threshold amounts. A taxpayer's income for purposes of this computation (modified adjusted gross income plus one-half of the individual's Social Security or Railroad Retirement Tier 1 benefit) will remain the same as under present law.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1993.

B. Business Provisions

1. Increase corporate tax rate for taxable income over $10 million

Present Law

The highest marginal tax rate imposed on the taxable income of corporations is 34 percent. The maximum rate of tax on corporate net capital gains is also 34 percent. This rate applies to income in excess of $75,000. Rates of 15 and 25 percent apply to taxable income ranges below $75,000. A corporation with taxable income in excess of $100,000 is required to increase its tax liability by the lesser of 5 percent of the excess or $11,750. This increase in tax phases out the benefits of the 15- and 25-percent rates for corporations with taxable income between $100,000 and $335,000; a corporation with taxable income in excess of $335,000, in effect, pays tax at a flat 34-percent rate.

Administration's Proposal

The proposal would provide a new 36-percent marginal tax rate on corporate taxable income in excess of $10 million. The maximum rate of tax on corporate net capital gains would also be 36 percent.

A corporation with taxable income in excess of $15 million would be required to increase its tax liability by the lesser of 3 percent of the excess or $200,000. This increase in tax would recapture the benefits of the 34-percent rate in a manner analogous to the recapture of the benefits of the 15- and 25-percent rates. Because the 36-percent rate would apply only to income in excess of $10 million, the vast majority of corporations would not be subject to the new rate.

Effective Date

The 36-percent marginal rate would be effective for taxable years beginning on or after January 1, 1993. Under existing law provisions regarding changes in tax rates during a taxpayer's taxable year (Code sec. 15), a fiscal year corporation would be required to use a "blended rate" for its fiscal year that includes January 1, 1993. Accordingly, the corporation's tax liability would be a weighted average of the tax resulting from applying the existing corporate rate schedule and the tax resulting from applying the changes described above, weighted by the number of days before and after January 1, 1993.

Penalties for the underpayment of estimated taxes would be waived for underpayments of 1993 taxes attributable to the changes in tax rates.

2. Deny deduction for lobbying expenses

Present Law

Trade or business expenses

Taxpayers engaged in a trade or business generally are allowed a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on such trade or business (sec. 162). Present-law section 162(e)(1) specifically provides a deduction for certain so-called "direct lobbying" expenses (including travel expenses, costs of preparing testimony, and a portion of dues) paid in carrying on a trade or business if such expenses are (1) in direct connection with appearances before, submissions of statements to, or sending communications to, committees, or individual members, of Congress or of any legislative body of a State or local government with respect to legislation or proposed legislation of direct interest to the taxpayer, or (2) in direct connection with communication of information between the taxpayer and an organization of which he is a member with respect to legislation or proposed legislation of direct interest to the taxpayer and to such organization.

No deduction is allowed for any amount paid for participation or intervention in any political campaign (i.e., "political campaign" expenses) or if paid in connection with any attempt to influence the general public, or segments thereof, with respect to legislative matters, elections, or referendums (i.e., "grass roots lobbying").

Lobbying expenditures which do not meet the "direct lobbying" requirements of section 162(e)(1) are not deductible as ordinary and necessary business expenses. Expenditures for institutional or "good will" advertising which keeps the taxpayer's name before the public, however, are generally deductible, provided such expenditures are related to the patronage the taxpayer might reasonably expect in the future.[1]

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[1] Prior to 1963, Treasury Department regulations (dating back to 1915) provided that all expenditures for lobbying purposes, for political campaign purposes, or for propaganda (including advertising) related to such purposes, were non-deductible. The validity of these regulations was upheld by the U.S. Supreme Court in Cammarano v. United States, 358 U.S. 498 (1959). In response to the Cammarano decision, Congress enacted, as part of the Revenue Act of 1962, the statutory rule contained in section 162(e)(1) specifically allowing a deduction for certain "direct lobbying" expenses.

Rules governing lobbying by tax-exempt organizations

Non-charitable exempt organizations.--Although most tax-exempt organizations other than charitable organizations (e.g., social welfare organizations and trade associations) generally may engage in unlimited lobbying efforts, some restrictions do exist. If political campaign or grass roots lobbying activities constitute a substantial part of the activities of an organization, such as a labor union or a trade association, the portion of dues or other payments to the organization that is attributable to such activities cannot be deducted by the payor under section 162.

Charitable organizations.--A charitable organization otherwise described in section 501(c)(3) is not entitled to tax-exempt status under that section if lobbying constitutes a substantial part of its activities. Lobbying activities are defined as attempts to influence legislation. An organization will be regarded as "attempting to influence legislation" if it (1) contacts, or urges the public to contact, members of a legislative body for the purpose of proposing, supporting, or opposing legislation; or (2) advocates the adoption or rejection of legislation. However, an organization will not lose its tax-exempt status merely because it engages in lobbying as an insubstantial part of its activities. Conducting nonpartisan research (while not advocating legislative action) is not considered lobbying for purposes of the section 501(c)(3) restriction, nor is seeking to protect the organization's own existence or responding to a governmental request for testimony.

A charity making the section 501(h) election is subject to a penalty excise tax on any "excess lobbying expenditures", as defined in section 4911. The excess lobbying expenditures are calculated on a formula based on the relationship of the exempt purpose expenditures and the allowable lobbying amounts (or the grass roots expenditures and the allowable grass roots amounts). Section 4911 defines lobbying, or attempts to influence legislation, as--

> "(A) any attempt to influence any legislation through an attempt to affect the opinions of the general public or any segment thereof, and
>
> (B) any attempt to influence any legislation through communication with any member or employee of a legislative body, or with any government official or employee who may participate in the formulation of the legislation."

However, section 4911(d)(2) specifically excludes the following activities from the definition of "influencing legislation":

(A) conducting nonpartisan analysis, study, or research;

(B) responding to a written request to provide technical advice or assistance to a governmental body;

(C) appearing before, or communicating with, any legislative body regarding a possible decision of such body which might affect the existence of the organization, its powers and duties, tax-exempt status, or the deduction of contributions to the organization;

(D) communicating between the organization and its members with respect to legislation or proposed legislation of direct interest to the organization and such members, unless the communication directly encourages members to (1) contact a legislative body in an attempt to influence legislation, or (2) urge other persons to attempt to affect the opinions of the general public or to contact a legislative body in an attempt to influence legislation; and

(E) communicating with government officials or employees to the extent that the principal purpose of such communications is not to influence legislation.

Private foundations.--Private foundations (as distinguished from public charities) generally are subject to penalty excise taxes under section 4945 if they engage in any direct or grass roots lobbying, even if not substantial. For purposes of section 4945, lobbying is defined similarly as under section 4911(d). Specifically, the section 4945 penalty excise taxes do not apply to nonpartisan analysis, the provision of technical advice to a governmental body in response to a written request, or lobbying before a legislative body with respect to a possible decision of such body which might affect the existence of the private foundation, its powers and duties, its tax-exempt status, or the deduction of contributions to such foundation.

Administration's Proposal

Taxpayers would no longer be allowed to deduct certain lobbying expenses under section 162. Lobbying expenses for purposes of this disallowance rule would be defined similarly to the definition of expenditures to influence legislation under section 4911(d)(1)(B)--that is, no deduction would be allowed for any amount paid or incurred in connection with any attempt to influence legislation through communication with any member or employee of a legislative body, or with any government official or employee who may participate in the formulation of legislation.

The disallowance rule would apply to attempts to influence legislation through communications with the executive branch as well as the legislative branch of the Federal, or any State or local, government. An exception to the general disallowance rule would be provided to permit taxpayers to deduct expenditures for providing technical advice or assistance to a governmental body or to a committee or other subdivision thereof in response to a specific written request by such governmental entity. (Exceptions similar to the other exceptions of present-law section 4911(d)(2), such as the exception for nonpartisan analysis, would not be provided.)

The present-law disallowance of business deductions for expenses of grass roots lobbying and participation in political campaigns would remain in effect. Existing rules which prevent charities from engaging in a substantial amount of lobbying also would remain in effect.

A flow-through rule would apply to disallow a deduction for a portion of the membership dues (or similar amounts) paid to an organization which engages in political or lobbying activities. The disallowed portion of such payments would be the portion allocable to political or lobbying expenditures incurred by the organization.[2] As under current law, however, trade associations and similar organizations would not lose their tax-exempt status by conducting lobbying activities. Trade associations and similar organizations would be required to report to their members (and the IRS) the portion of membership dues (or similar payments) allocable to lobbying activities. The Secretary of the Treasury would be granted authority to provide by regulation that this reporting requirement generally applicable to organizations would not apply where unnecessary to effectuate the purposes of the provision (e.g., where an organization incurs insubstantial lobbying expenses, or where the disallowed portion of such expenditures would not materially affect the tax liability of dues-paying members).

Penalties would be imposed on an organization for failing to meet its reporting requirements. In addition to the normal reporting penalties (generally, $50 for each failure to report to the IRS or organization member), a special penalty would be imposed on an organization which materially underreports its lobbying expenses to its members. This special penalty would be equal to the amount of lobbying or political expenses not reported multiplied by the highest corporate tax rate (to approximate the amount of tax which would have been paid by the organization's members had they been notified of the disallowed amounts).

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[2] For this purpose, lobbying expenditures incurred by an organization would be allocated first to dues paid to the organization, and any excess amount of lobbying expenditures would be carried forward and allocated to dues paid to the organization in the following year.

Effective Date

The proposal would be effective for amounts paid or incurred after December 31, 1993.

3. Mark-to-market accounting method for dealers in securities

Present Law

A taxpayer that is a dealer in securities is required for Federal income tax purposes to maintain an inventory of securities held for sale to customers. A dealer in securities is allowed for Federal income tax purposes to determine (or value) the inventory of securities held for sale based on: (1) the cost of the securities; (2) the lower of the cost or market value of the securities; or (3) the market value of the securities.

If the inventory of securities is determined based on cost, unrealized gains and losses with respect to the securities are not taken into account for Federal income tax purposes. If the inventory of securities is determined based on the lower of cost or market value, unrealized losses (but not unrealized gains) with respect to the securities are taken into account for Federal income tax purposes. If the inventory of securities is determined based on market value, both unrealized gains and losses with respect to the securities are taken into account for Federal income tax purposes.

For financial accounting purposes, the inventory of securities generally is determined based on market value.

Administration's Proposal

In general

The proposal would provide two general rules (the "mark-to-market rules") that apply to certain securities that are held by a dealer in securities. First, any such security that is inventory in the hands of the dealer would be required to be included in inventory at its fair market value. Second, any such security that is not inventory in the hands of the dealer and that is held as of the close of any taxable year would be treated as sold by the dealer for its fair market value on the last business day of the taxable year and any gain or loss would be required to be taken into account by the dealer in determining gross income for that taxable year.[1] For this purpose, fair market value generally

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[1] For purposes of the proposal, a security would be treated as sold to a person that is not related to the dealer even if the security is a contract between the dealer and a related person. Thus, for example, Code sections 267 and 707(b) would not apply to any loss that would be required to be taken into account under the proposal.

In addition, a security subject to the proposal would not be treated as sold and reacquired for purposes of Code section 1091. Section 1092 would apply to any loss recognized by the mark-to

would be determined by valuing each security on individual security basis.

If gain or loss is taken into account with respect to a security by reason of the second mark-to-market rule, then the amount of gain or loss subsequently realized as a result of a sale, exchange, or other disposition of the security, or as a result of the application of the mark-to-market rules, would be appropriately adjusted to reflect such gain or loss. In addition, the proposal would authorize the Treasury Department to promulgate regulations that provide for the application of the second mark-to-market rule at times other than the close of a taxable year.

Character of gain or loss

Any gain or loss taken into account under the proposal (or any gain or loss recognized with respect to a security that would be subject to the proposal if the security had been held at the close of the taxable year) generally would be treated as ordinary gain or loss. This special character rule would not apply to any security that is a hedge of a security that is not subject to the mark-to-market rules or of a position, right to income, or a liability that is not a security in the hands of the taxpayer. Anti-abuse rules would be adopted to prevent straddle opportunities.

Definitions

A dealer in securities would be defined as any taxpayer that either (1) regularly purchases securities from, or sells securities to, customers in the ordinary course of a trade or business, or (2) regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business.

A security would be defined as: (1) any share of stock in a corporation; (2) any partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust; (3) any note, bond, debenture, or other evidence of indebtedness; (4) any interest rate, currency, or equity notional principal contract (but not any other notional principal contract such as a notional principal contract that is based on the price of oil, wheat, or other commodity); and (5) any evidence of an interest in, or any derivative financial instrument in, a security described in (1) through (4) above or any currency, including any option, forward contract, short position, or any similar financial instrument in such a security or currency.

In addition, a security would be defined to include any

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market rules, but will have no effect if all offsetting positions making up the straddle are subject to the mark-to market rules.

position if: (1) the position is not a security described in the preceding paragraph; (2) the position is a hedge with respect to a security described in the preceding paragraph; and (3) before the close of the day on which the position was acquired or entered into (or such other time as the Treasury Department may specify in regulations), the position is clearly identified in the dealer's records as a hedge with respect to a security described in the preceding paragraph. A security, however, generally would not include a contract to which section 1256(a) applies, unless such contract is a hedge of a security to which the proposal would apply.

Exceptions to the mark-to-market rules

Notwithstanding the definition of security, the mark-to-market rules generally do not apply to: (1) any security that is held for investment; (2) any evidence of indebtedness that is acquired (including originated) by a dealer in the ordinary course of a trade or business of the dealer but only if the evidence of indebtedness is not held for sale; (3) any security which is a hedge with respect to a security that is not subject to the mark-to-market rules (i.e., any security that is a hedge with respect to (a) a security held for investment or (b) an evidence of indebtedness described in (2)), or (3) any security which is a hedge with respect to a position, right to income, or a liability that is not a security in the hands of the taxpayer.[2]

In addition, the exceptions to the mark-to-market rules would not apply unless the security is clearly identified in the dealer's records as being described in one of the exceptions listed above. A dealer may not treat a security that is identified as a hedge or as an investment as also held in its capacity as a dealer (thus, securities identified as qualifying for one of the exceptions to the mark-to-market rules may not be accounted for using the lower-of-cost-or-market or other inventory method of accounting). The Treasury Secretary would be authorized to issue regulations that would prevent a dealer from avoiding the mark-to-market rules by treating securities held for sale or as inventory as a security that qualifies for one of the exceptions listed above. Finally, a dealer would be required to continue to hold the security in a capacity that qualifies the security for one of the exceptions listed above.

Other rules

The uniform cost capitalization rules of section 263A and the

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[2] Whether or not a security or evidence of indebtedness would be marked-to-market under the applicable financial accounting rules would not be dispositive for purposes of determining whether such security or evidence of indebtedness would be treated as held for investment or as not held for sale under the proposal.

rules of section 263(g) that require the capitalization of certain interest and carrying charges in the case of straddles would not apply to any security to which the mark-to-market rules apply because the fair market value of the security should include the costs the dealer would otherwise capitalize.

In addition, the Treasury Department would be authorized to promulgate such regulations as may be necessary or appropriate to carry out the proposal, including rules to prevent the use of year-end transfers, related persons, or other arrangements to avoid the proposal.

Effective Date

The proposal would apply to taxable years ending on or after December 31, 1993. A taxpayer that would be required to change its method of accounting to comply with the requirements of the provision is treated as having initiated the change in method of accounting and as having received the consent of the Treasury Department to make such change.

The net amount of the section 481(a) adjustment would be taken into account ratably over a 5-taxable year period beginning with the first taxable year ending on or after December 31, 1993.

To the extent that a portion of the section 481(a) adjustment of a taxpayer is attributable to the use of the LIFO inventory method of accounting for any qualified security, such portion of the adjustment would be taken into account ratably over the shorter of (1) a 20-taxable year period or (2) the number of years the taxpayer (or any predecessor) had utilized the LIFO inventory method, beginning with the first taxable year ending on or after December 31, 1993. In no event would the period be less than 5 years. For this purpose, "qualified security" would mean any security acquired (1) by a floor specialist (as defined in section 1236(d)(2)) in connection with the specialist's duties as a specialist on an exchange, but only if the security is one in which the specialist is registered with the exchange or (2) by a taxpayer who is a market maker in connection with the taxpayer's duties as market maker, but only if (a) the security is included on the National Association of Security Dealers Automated Quotation System, (b) the taxpayer is registered as a market maker in such security with the National Association of Security Dealers, and (c) as of the last day of the taxable year preceding the taxpayer's first taxable year ending on or after December 31, 1993, the taxpayer (or a predecessor of the taxpayer) has been actively engaged as a market maker in such security for a 2-year period ending on such date (or, if shorter, the period beginning 61 days after the security was listed in such quotation system and ending on such date.) The portion of the section 481(a) adjustment that is attributable to the use of the LIFO inventory method of accounting for any qualified security would be determined under the rules described in section 312(n)(4) (without regard to the effective date of such section). In addition, the portion of the

section 481(a) adjustment that is attributable to the use of the LIFO inventory method of accounting for qualified securities could not exceed the taxpayer's overall section 481(a) adjustment for all securities under the proposal.

The principles of section 8.03(1) and (2) of Rev. Proc. 92-20, 1992-12 I.R.B. 10, would apply to the section 481(a) adjustment by taking into account all securities of a dealer that are subject to the mark-to-market rules (including those securities that are not inventory in the hands of the dealer).

No addition to tax would apply to certain underpayments of estimated tax to the extent that the underpayments are attributable to the enactment of this proposal.

4. Tax treatment of certain FSLIC financial assistance

Present Law and Background

A taxpayer may claim a deduction for a loss on the sale or other disposition of property only to the extent that the taxpayer's adjusted basis for the property exceeds the amount realized on the disposition and the loss is not compensated for by insurance or otherwise (sec. 165 of the Code). In the case of a taxpayer on the specific charge-off method of accounting for bad debts, a deduction is allowable for the debt only to the extent that the debt becomes worthless and the taxpayer does not have a reasonable prospect of being reimbursed for the loss. If the taxpayer accounts for bad debts on the reserve method, the worthless portion of a debt is charged against the taxpayer's reserve for bad debts, potentially increasing the taxpayer's deduction for an addition to this reserve.

A special statutory tax rule, enacted in 1981, excluded from a thrift institution's income financial assistance received from the Federal Savings and Loan Insurance Corporation (FSLIC)[1], and prohibited a reduction in the tax basis of the thrift institution's assets on account of the receipt of the assistance. Under the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), taxpayers generally were required to reduce certain tax attributes by one-half the amount of financial assistance received from the FSLIC pursuant to certain acquisitions of financially troubled thrift institutions occurring after December 31, 1988. These special rules were repealed by FIRREA, but still apply to transactions that occurred before May 10, 1989.

Prior to the enactment of FIRREA, the FSLIC entered into a number of assistance agreements in which it agreed to provide loss protection to acquirers of troubled thrift institutions by compensating them for the difference between the book value and sales proceeds of "covered assets." "Covered assets" typically are assets that were classified as nonperforming or troubled at the time of the assisted transaction but could include other assets as well. Many of these covered assets are also subject to yield maintenance guarantees, under which the FSLIC guaranteed

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[1] Until it was abolished by the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), FSLIC insured the deposits of its member savings and loan associations and was responsible for insolvent member institutions. FIRREA abolished FSLIC and established the FSLIC Resolution Fund (FRF) to assume all of the assets and liabilities of FSLIC (other than those expressly assumed or transferred to the Resolution Trust Corporation (RTC)). FRF is administered by the Federal Deposit Insurance Corporation (FDIC). The term "FSLIC" is used hereafter to refer to FSLIC and any successor to FSLIC.

the acquirer a minimum return or yield on the value of the assets. The assistance agreements also generally grant the FSLIC the right to purchase covered assets. In addition, many of the assistance agreements permit the FSLIC to order assisted institutions to write down the value of covered assets on their books to fair market value in exchange for a payment in the amount of the write-down.

Under most assistance agreements, one or more Special Reserve Accounts are established and maintained to account for the amount of FSLIC assistance owed by the FSLIC to the acquired entity. The assistance agreements generally specify the precise circumstances under which amounts with respect to covered assets are debited to an account. Under the assistance agreements, these debit entries generally are made subject to prior FSLIC direction or approval. When amounts are so debited, the FSLIC generally becomes obligated to pay the debited balance in the account to the acquirer at such times and subject to such offsets as are specified in the assistance agreement.

In September 1990, the Resolution Trust Corporation (RTC), in accordance with the requirements of FIRREA, issued a report to Congress and the Oversight Board of the RTC on certain FSLIC-assisted transactions (the "1988/89 FSLIC transactions"). The report recommended further study of the covered loss and other tax issues relating to these transactions. A March 4, 1991 Treasury Department report ("Treasury report") on tax issues relating to the 1988/89 FSLIC transactions concluded that deductions should not be allowed for losses that are reimbursed with exempt FSLIC assistance. The Treasury report states that the Treasury view is expected to be challenged in the courts and recommended that Congress enact clarifying legislation disallowing these deductions.[2]

Administration's Proposal

General rule

The proposal would treat FSLIC assistance with respect to any loss of principal, capital, or similar amount upon the disposition of an asset would be taken into account as compensation for such loss for purposes of Code section 165. FSLIC assistance with respect to any debt would be taken into account under Code sections 166, 585 and 593 for purposes of determining whether such debt is worthless (or the extent to which such debt is worthless) and in determining the amount of

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[2] Department of the Treasury, Report on Tax Issues Relating to the 1988/89 Federal Savings and Loan Insurance Corporation Assisted Transactions, March 1991, pp. 16-17.

any addition to a reserve for bad debts. For this purpose, FSLIC assistance means any assistance or right to assistance with respect to a domestic building and loan association (as defined in Code sec. 7701(a)(19) without regard to subparagraph (C) thereof) pursuant to section 406(f) of the National Housing Act or section 21A of the Federal Home Loan Bank Act (or under any similar provision of law).

Financial assistance to which the FIRREA amendments apply

The proposal would not apply to any financial assistance to which the amendments made by section 1401(a)(3) of FIRREA apply.

No inference

No inference would be intended as to prior law or as to the treatment of any item to which the proposal does not apply.

Effective Date

In general

The proposal would apply to financial assistance credited on or after March 4, 1991, with respect to: (1) assets disposed of and charge-offs made in taxable years ending on or after March 4, 1991; and (2) assets disposed of and charge-offs made in taxable years ending before March 4, 1991, but only for purposes of determining the amount of any net operating loss carryover to a taxable year ending on or after March 4, 1991.

For this purpose, financial assistance generally would be considered to be credited when the taxpayer made an approved debit entry to a Special Reserve Account required to be maintained under the assistance agreement to reflect the asset disposition or charge-off. An amount will also be considered to be credited prior to March 4, 1991 if the asset was sold, with prior FSLIC approval, before that date.

Application to certain net operating losses

The proposal would apply to the determination of any net operating loss carried into a taxable year ending on or after March 4, 1991, to the extent that the net operating loss is attributable to a loss or charge-off for which the taxpayer had a right to FSLIC assistance which had not been credited before March 4, 1991.

Estimated Tax Payments

The proposal would waive additions to tax for underpayments relating to certain estimated tax payments.

5. Extend corporate estimated tax rules

Present Law

A corporation is subject to an addition to tax for any underpayment of estimated tax. For taxable years beginning after June 30, 1992, and before 1997, a corporation does not have an underpayment of estimated tax if it makes four equal timely estimated tax payments that total at least 97 percent of the tax liability shown on its return for the current taxable year. A corporation may estimate its current year tax liability prior to year-end by annualizing its income through the period ending with either the month or the quarter ending prior to the estimated tax payment due date. For taxable years beginning after 1996, the 97-percent requirement becomes a 91-percent requirement.

A corporation that is not a "large corporation" generally may avoid the addition to tax if it makes four timely estimated tax payments each equal to at least 25 percent of its tax liability for the preceding taxable year. A large corporation may use this rule with respect to its estimated tax payment for the first quarter of its current taxable year. A large corporation is one that had taxable income of $1 million or more for any of the three preceding taxable years.

Administration's Proposal

The proposal would permanently extend the 97-percent requirement applicable to corporate estimated tax payments. The proposal would not alter the present-law rules permitting the payment of estimated taxes based on a corporation's tax liability for its preceding taxable year.

Effective Date

The proposal would be effective for taxable years beginning after 1996.

6. Limitation on section 936 credit

Present Law

Certain domestic corporations with business operations in U.S. possessions (including, for this purpose, Puerto Rico and the U.S. Virgin Islands) may elect under section 936 of the Code generally to eliminate the U.S. tax (including the alternative minimum tax) on certain income related to their operations in the possessions. Income exempt from U.S. tax under this provision falls into two broad categories: business income, which in order to be exempt must be income treated as foreign source income derived from the active conduct of a trade or business within a U.S. possession; and investment income, which in order to be exempt must be derived from certain investments in the possessions or in certain Caribbean Basin countries. The investment income exempted under the provision is known as "qualified possession source investment income" (QPSII).[1] For these and other purposes, income derived within a possession is encompassed within the term "foreign source income."

In order to qualify for the section 936 credit, a domestic corporation must satisfy two requirements. Under one requirement, the corporation must be treated as deriving at least 75 percent of its gross income from the active conduct of a trade or business within a U.S. possession over a three-year period. Under the other requirement, the corporation must be treated as deriving at least 80 percent of its gross income from sources within a possession during that same three-year period.

Three alternative rules are provided that relate to allocating income from intangible property between a domestic corporation that elects the section 936 credit (a "possession corporation") and its U.S. shareholders. The general rule is to prohibit the possession corporation from earning any return on intangible property. A possession corporation can instead elect to subject itself to one of two alternative rules, if it satisfies certain conditions.

One such rule is referred to as the "cost sharing method." Use of this method requires the possession corporation to pay other members of its affiliated group of corporations an amount that is the greater of: (1) the total amount of the affiliated group's research and development expenses concerning the possession corporation's product area, multiplied by 110 percent of the proportion of its

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[1] In contrast to the foreign tax credit, the possessions tax credit is a "tax sparing" credit. That is, the credit is granted whether or not the electing corporation pays income tax to the possession.

sales as compared to total product area sales of the group; or (2) the amount of the royalty payment or inclusion that would be required under sections 367(d) and 482 with respect to intangible assets which the possession corporation is treated as owning under the cost sharing method, were the possession corporation a foreign corporation.

The alternative elective rule for allocating income from intangible property between a possession corporation and its U.S. shareholders is a "profit split" approach. This method generally permits allocation to the possession corporation of 50 percent of the affiliated group of U.S. corporations' combined taxable income derived from sales of products which are manufactured in a possession.

Dividends paid by a possession corporation to a U.S. shareholder may qualify for the deduction for dividends received from a domestic corporation (sec. 243). In cases where at least 80 percent of the stock of the possession corporation is owned by a single domestic corporation, the possession corporation's possession source income generally may be distributed without incurring any regular U.S. income tax. However, such a dividend constitutes adjusted current earnings of the shareholder for purposes of computing the alternative minimum tax.

Taxes paid or accrued by possession corporations to foreign countries or possessions on income which is taken into account in determining the section 936 credit are neither allowable for purposes of determining the foreign tax credit nor deductible.

Administration's Proposal

The section 936 credit would be determined as under present law, but would be subject to the following two limitations. First, the credit allowed against U.S. tax on business income (i.e., income derived from the active conduct of a possession-based business, or from the sale of assets used in such a business) would be limited to 60 percent of the qualified wages the possession corporation pays to its employees in the possessions. Second, the credit allowed against U.S. tax on QPSII would be limited in cases where the possession corporation's assets that generate QPSII exceed 80 percent of its business property in the possessions. In such a case, no credit would be allowed for the portion of its QPSII attributable to QPSII assets which exceed that 80-percent threshold.

For purposes of the first limitation, qualified wages generally are defined by reference to the Federal Unemployment Tax Act (FUTA) definition of wages. The amount of wages taken into account for each employee would be limited to the maximum earnings subject to tax under the

OASDI portion of social security (currently $57,600), with appropriate adjustments in the cases of part-time employees and of employees whose principal place of employment is not within a possession for the entire year. For this purpose, wages generally would not include amounts paid to employees assigned by the employer to perform services for another person.

For purposes of the limitation on the credit against U.S. tax on QPSII, the amount of a possession corporation's QPSII assets for a taxable year is determined by computing the average of the aggregate adjusted bases (for purposes of computing earnings and profits) of its assets which generate QPSII as of the close of each quarter of that year. A possession corporation's business property for a taxable year is determined by computing the average of the aggregate adjusted bases (for purposes of computing earnings and profits) of tangible property used in a possession by the corporation in an active trade or business.

The proposal would allow an affiliated group of corporations to elect to consolidate related possession corporations for purposes of determining their section 936 credit. The consolidated credit would be allocated among the possession corporations under rules prescribed by the Treasury Secretary.

If the section 936 credit of a possession corporation is reduced by either of the limitations for a taxable year, then the proposal would permit the corporation to claim a deduction for a portion of its income taxes paid or accrued to a possession for that year. The portion of the taxes so deductible would be the portion that is allocable on a pro rata basis to the corporation's taxable income (computed before taking into account any possession tax) the U.S. tax on which is not offset by the section 936 credit.

For purposes of computing alternative minimum tax for a recipient of dividends from a possession corporation, the proposal would create a new separate foreign tax credit limitation category for such dividends.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1993, except that, for taxable years beginning in 1994 or 1995, possession corporations may elect to claim an alternative credit not subject to the two limitations described above. Under this alternative, the credit would be 80 percent of the current law credit for taxable years beginning in 1994 and 60 percent for taxable years beginning in 1995. Under the alternative credit, taxes imposed by the possessions on income the U.S. tax on which is not offset by the credit would be deductible by the

possession corporation.

7. Enhance earnings stripping rules

Present Law

Interest expenses of a U.S. corporate taxpayer are generally deductible, whether or not the interest is paid to a related party and whether or not the interest income is subject to U.S. taxation in the hands of the recipient. In certain cases where interest is paid by a corporation to a related person, and no U.S. tax is imposed on the recipient's interest income, the so-called "earnings stripping rules" in the Code provide for denial of interest deductions by the corporate payor to the extent that the corporation's net interest expenses exceed 50 percent of its adjusted taxable income. The disallowance is limited by, among other things, the amount of tax-exempt interest paid to related persons. The disallowance does not apply to interest on debt with a fixed term which was issued on or before July 10, 1989, or which was issued after that date pursuant to certain written binding contracts in effect on that date.

The Treasury is authorized to provide such regulations as may be appropriate to prevent the avoidance of the purposes of this provision, including regulations that would disallow deductions for interest paid to unrelated creditors in certain cases: for example, certain cases that involve guarantees of the debt by parties related to the debtor. The legislative history accompanying the bill enacting the provision, however, indicates an intent that such regulations not generally subject third-party interest to disallowance whenever a guarantee is given in the ordinary course. The legislative history further indicates an expectation that any such regulations would not apply to debt outstanding prior to notice of the rule if and to the extent that the regulations depart from positions the Service and Treasury might properly take under analogous principles of law that would recharacterize guaranteed debt as equity.

To date, Treasury has promulgated no proposed or final regulations that interpret the application of the earnings stripping rules to third-party debt that is guaranteed by a person related to the debtor.

Administration's Proposal

Interest would be subject to disallowance under the earnings stripping rules without regard to whether it is interest on a fixed-term obligation issued before, on, or after July 10, 1989. Interest paid on a loan from an unrelated party generally would be treated under the earnings stripping rules as interest paid to a related person with respect to which no U.S. tax is imposed if no gross-basis U.S. income tax is imposed on the interest (whether or not the interest recipient is subject to net-basis U.S. income tax with respect to that interest), a related person guaranteed the loan, and the related person is either exempt from U.S. Federal income tax or is a foreign person. Exceptions would

apply where the taxpayer controls the guarantor, and in cases, identified by regulation, where the interest on the indebtedness would have been subject to net basis tax if the interest had been paid to the guarantor. Except as provided in regulations, a guarantee would be defined to include any arrangement under which a person directly or indirectly assures, on a conditional or unconditional basis, the payment of another's obligation.

Effective Date

The proposal would apply to any interest paid or accrued in taxable years beginning after December 31, 1993.

C. Foreign Tax Provisions

1. Require current taxation of certain earnings of controlled foreign corporations

Present Law

In general

U.S. persons generally are taxed currently by the United States on their worldwide income. U.S. tax on foreign source income may be reduced by credits for foreign income taxes paid by the U.S. person. Foreign income earned by a foreign corporation, the stock of which is owned in whole or in part by U.S. persons, generally is not taxed by the United States until the foreign corporation repatriates those earnings by payment of a dividend to its U.S. stockholders. If a foreign corporation pays a dividend to a domestic corporation that owns 10 percent or more of the voting stock of the foreign corporation, the domestic corporation may receive credits for foreign income taxes paid by the foreign corporation. This is sometimes known as the "indirect" foreign tax credit.

Controlled foreign corporations

A "U.S. shareholder" of a U.S.-controlled foreign corporation--i.e., a U.S. person that is treated as owning at least 10 percent of the foreign corporation's voting stock--may be taxed by the United States on certain earnings of the controlled foreign corporation that have not been distributed by the foreign corporation to the U.S. shareholder. Such "inclusions" of undistributed controlled foreign corporation earnings are triggered by two different provisions of the controlled foreign corporation rules.

Under one such provision, a U.S. shareholder is taxed currently on its proportionate share of the controlled foreign corporation's "subpart F income" earned during the taxable year. Subpart F income typically is foreign income that is relatively movable from one taxing jurisdiction to another and that is subject to low rates of foreign tax. While subpart F income generally includes dividends received by the controlled foreign corporation, an exception applies to certain dividends from related corporations organized and operating in the same foreign country as the controlled foreign corporation.

The other provision taxing U.S. shareholders on undistributed controlled foreign corporation earnings applies to the controlled foreign corporation's total current or accumulated earnings (other than subpart F income), to the extent of an increase in the amount of those earnings invested by the controlled foreign corporation in certain U.S. property (as defined in Code section 956).

Like the U.S. tax on dividends, the U.S. tax on inclusions of subpart F income and on inclusions based on earnings invested in U.S. property may be reduced by credits for foreign income taxes, including "indirect" credits for taxes paid by the controlled foreign corporation.

Receipt of previously taxed earnings and profits

Earnings and profits of a controlled foreign corporation that have been included in the income of U.S. shareholders before actual repatriation are not taxed again when such earnings are in fact distributed to the U.S. shareholders. A U.S. shareholder is permitted to increase its foreign tax credit limitation in the year of the distribution of previously taxed earnings and profits. The increase equals the excess of the amount by which its foreign tax credit limitation for the year of the income inclusion was increased as a result of that inclusion, over the amount of foreign taxes which were allowable as a credit in that year and which would not have been so allowable but for the income inclusion. The increase in the foreign tax credit limitation may not, however, exceed the amount of the foreign taxes actually paid with respect to the distribution of previously taxed earnings and profits. All such determinations are made separately for each foreign tax credit limitation category.

Passive foreign investment companies

If any foreign corporation (including a controlled foreign corporation) is a "passive foreign investment company" (PFIC), U.S. persons (including 10-percent "U.S. shareholders") that own any stock in the PFIC may be subject to one of two other sets of operating rules that eliminate or reduce the benefits of deferral. A PFIC generally is defined as any foreign corporation if (1) 75 percent or more of its gross income for the taxable year consists of passive income, or (2) 50 percent or more of its assets consist of passive assets, defined as assets that produce, or are held for the production of, passive income.

A U.S. person owning PFIC stock may elect to include currently in gross income its share of the PFIC's total earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received. A nonelecting U.S. person owning PFIC stock pays no current tax on the PFIC's undistributed income. However, when realizing income earned through ownership of PFIC stock (such as certain dividends distributed by the PFIC or capital gains from selling PFIC stock), the nonelecting U.S. person may pay an additional interest charge.

Administration's Proposal

Inclusions based on excess passive assets

Require any "U.S. shareholder" of a controlled foreign corporation to include in income the lesser of (a) its pro rata share of the controlled foreign corporation's passive assets that exceed 25 percent of the foreign corporation's total assets, reduced by amounts that were previously included under this provision in the income of the U.S. shareholder (or a predecessor in interest); or (b) its pro rata share of the foreign corporation's total current or accumulated earnings, excluding amounts that were previously included under this provision or section 956 in the income of the U.S. shareholder (or a predecessor in interest). Such lesser amount, however, shall be included only (as under present law in the case of an actual distribution) to the extent that it exceeds the foreign corporation's undistributed income that was previously included as subpart F income in the income of the U.S. shareholder (or a predecessor in interest). All amounts under this provision would be determined after the application of section 956 (and income inclusions thereunder) for the taxable year.

The controlled foreign corporation's assets would be measured using an average of adjusted basis (as determined for purposes of calculating earnings and profits), as of the close of each quarter of the taxable year. Passive assets would be defined as under the PFIC rules, which themselves are modified under the proposal (see description of modifications below). The PFIC look-through rules would apply.

Property that would be described both as a passive asset under this provision and as U.S. property under section 956 would be treated only as U.S. property under section 956.

Proper adjustments would be made to the measurement of assets and earnings in the case of any foreign corporation that ceases to be U.S.-controlled during the taxable year.

Modification of section 956

Treat earnings invested by a controlled foreign corporation in U.S. property under revised rules that parallel those that would govern the treatment of earnings invested in passive assets in excess of 25 percent of total assets, as described above. Under the revised rules, the amount subject to inclusion by each U.S. shareholder under section 956 would be the lesser of (a) its pro rata share of the amount of U.S. property held by the controlled foreign corporation, reduced by amounts that were previously included under section 956 (as revised or under present law) in the income of the U.S. shareholder (or a predecessor in interest); or (b) its pro rata share of the foreign corporation's total current or accumulated earnings, excluding amounts that were previously included under the excess passive assets provision or under section 956 (as revised or under present law) in the income of the U.S. shareholder (or a predecessor in interest). Such lesser amount, however, shall be included only (as under present law in the case of an actual

distribution) to the extent that it exceeds the foreign corporation's undistributed income that was previously included as subpart F income in the income of the U.S. shareholder (or a predecessor in interest).

The controlled foreign corporation's assets would be measured using an average of adjusted basis (as determined for purposes of calculating earnings and profits), as of the close of each quarter of the taxable year, less any liability to which the property is subject (as under present law).

Same-country dividend rule

Limit the application of the subpart F same-country exception in the case of certain dividends received by controlled foreign corporations. Amounts distributed with respect to stock owned by the controlled foreign corporation would not qualify for the same-country exception to the extent that the distributed earnings and profits were accumulated by the distributing corporation during periods when the controlled foreign corporation did not hold the stock.

Effect on foreign tax credit limitation of distributions of previously taxed earnings

Receipt of previously taxed income by a U.S. shareholder of one or more controlled foreign corporations would increase the U.S. shareholder's foreign tax credit limitation to the extent of the aggregate amount in a single "excess limitation account" maintained by that U.S. shareholder for each of its separate foreign tax credit limitation categories. That account would reflect the cumulative amount by which the taxpayer's foreign tax credit limitation had been increased on account of subpart F income inclusions (in excess of the foreign taxes allowed as a credit on account of such inclusions) in taxable years beginning after September 30, 1993, less the total amount by which the account was used to increase the U.S. shareholder's foreign tax credit limitation upon the actual distribution of such previously taxed earnings and profits.

Measurement of assets, passive income, and distributions for PFIC purposes in the case of U.S. shareholders of controlled foreign corporations

In testing a controlled foreign corporation for PFIC status with respect to its "U.S. shareholders," measure assets by adjusted basis as determined for purposes of calculating earnings and profits, with no option to use fair market value.

In addition, the proposal would exclude from the definition of passive income under the PFIC rules all income derived in the active conduct of a securities business by certain corporations registered in the United States as brokers or dealers in securities, and, to the extent provided in Treasury regulations,

by any other corporation engaged in the active conduct of a business as a broker or dealer in securities. As with the asset valuation rule above, this exclusion would apply only to a controlled foreign corporation, and only for purposes of the treatment of its U.S. shareholders.

Inclusions of income on account of investments of earnings of a controlled foreign corporation in U.S. property, or ownership of excess passive assets, would be treated as distributions for purposes of computing the interest charge on excess distributions to the U.S. shareholders of PFICs that are controlled foreign corporations.

Treatment of certain leased assets for PFIC purposes

In testing any foreign corporation for PFIC status, treat certain leased property as assets held by the foreign corporation to the extent of the unamortized portion of the present value of payments under the lease.

Effective Date

The provisions generally would be effective for taxable years of foreign corporations beginning after September 30, 1993, and for taxable years of domestic shareholders in which or with which such taxable years end.

The excess passive assets proposal would be phased in during taxable years beginning after September 30, 1993, and before October 1, 1997. The amount of income included under the proposal would be 20 percent of the amount otherwise determined with respect to the first year of the phase-in period, 25 percent during the second year, 35 percent during the third year, and 50 percent during the fourth year. The proposal would be 100-percent effective for taxable years beginning after September 30, 1997. Corporations that become subject to the proposal after the beginning of the phase-in period would join the phase-in schedule in progress.

The provision modifying the rules for increasing foreign tax credit limitation upon distributions of previously taxed income would be effective for actual distributions of earnings that were included under subpart F in taxable years of U.S. shareholders beginning after September 30, 1993.

2. Allocation of research expense and treatment of royalties as passive income for purposes of foreign tax credit limitation

Present Law

In general

In order that the foreign tax credit will offset only the U.S. tax on the taxpayer's foreign source taxable income, a limitation formula is prescribed in the Code. This foreign tax credit limitation is computed separately for certain categories of income, including passive income.

Separate limitation for passive income

Foreign personal holding company income

Subject to the "look-through" rule and other exceptions described below, passive income generally is any income of a kind which would be foreign personal holding company income, if earned by a controlled foreign corporation. Foreign personal holding company income generally includes royalties. Royalties are not foreign personal holding company income, however, if received in the active conduct of a trade or business from unrelated persons. Also excluded from foreign personal holding company income are certain rents and royalties received from a related corporation for the use of property within the country in which the recipient was created or organized.

The high-tax kick-out

Passive income excludes high-taxed income. For this purpose, high-taxed income is any income which would otherwise be passive income if the effective rate of foreign tax on the income exceeds the highest rate of U.S. corporate or individual tax (whichever applies). In determining the effective rate of foreign tax on income, regulations provide that taxpayers may group certain individual items of income, and the taxes associated with those items, together. Under current regulations, taxpayers are required, among other things, to group separately income subject to withholding taxes of 15 percent or greater, income subject to withholding taxes at rates less than 15 percent, and income subject to no withholding taxes.

Look-through rules

Royalties received or accrued from a controlled foreign corporation in which the payee is a U.S. shareholder generally are treated as income subject to the general limitation or as income subject to each separate limitation category to the extent properly allocable to income of the controlled foreign corporation subject to each of these limitations. A "look-through rule," as the foregoing rule is commonly known, also applies to dividends, interest, and rents received or accrued

4. Transfer pricing initiative

Present Law

A "substantial" valuation misstatement may result in a penalty of 20 percent of the understatement of tax attributable to the substantial valuation misstatement (sec. 6662(a) and (b)(2)). The penalty for a "gross" valuation misstatement is 40

5. Deny portfolio interest exemption for contingent interest

Present Law

Deductibility of interest

to the tax paid by the power producer on the fossil fuel used in generation (or to the otherwise applicable tax if the electricity is not generated from fossil fuel). The independent power producer would receive a credit for any energy tax paid in the production of such electricity.

Tax rates and determination of Btu content

Tax rates.--A base rate of $0.257 per million Btus would be imposed on all taxable energy sources. A supplemental tax of $0.342 per million Btus (a total rate of $0.599 per million Btus) would be imposed on all petroleum products other than heating oil used for residential heating and liquefied petroleum gases.

The stated tax rates would be phased in at one-third of the full rates beginning July 1, 1994, and at two-thirds of the full

	owner would collect and remit the tax
Natural gas	Local distribution company (or end user receiving gas directly from the transmission pipeline) would be liable; pipeline would collect and remit the tax
Coal	Large users: end user would be liable and also would remit the tax Small and residential users: seller would be liable and also would remit the tax
Hydro- and nuclear-generated electricity	Utility (or other producer) would be liable and also would remit the tax

Exemptions

The following would not be subject to tax:

(1) Solar, wind, and geothermal energy.

(2) Ethanol, ETBE, and similar ethers.

(3) Biomass, including landfill gas, wood waste, and bagasse (sugar cane biomass).

(4) Municipal solid waste and tires burned as fuel.

(5) Nonfuel products such as asphalt, lubricants, and waxes.

(6) Hydroelectricity from pump storage.

(7) Imported electricity if the importer establishes that an energy source other than fossil fuels, hydropower, or nuclear power was used to generate the electricity.

(8) Coal used in the production of synthetic natural gas.

(9) Crude oil or natural gas used, on the premises where it is produced, to produce crude oil or natural gas.

Crude oil or petroleum products (other than natural gas) used in a refinery or natural gas used in a natural gas processing or fractionation plant would not be subject to the use tax.

Additional exemptions, generally administered by providing a credit or refund of taxes paid, would be provided for:

(1) Exports of taxable energy sources, including all electricity.

(2) Nonfuel uses (e.g., feedstock uses) of fossil fuels.

(3) Ship and jet fuel used in international commercial transportation.

(4) Methanol, MTBE, and similar ethers.

(5) Refined petroleum products used in the production of synthetic natural gas.

(6) Coal seam methane from biomass or coal mining operations.

(7) Natural gas and coal used in enhanced oil recovery for heavy oil.

(8) Heating oil used in residential heating (supplemental rate only).

The tax would not include any exemptions based on the character of the purchaser of an otherwise taxable product (e.g., fuel and electricity purchased by the U.S. Government would be subject to tax).

Utility flow-through

Utilities would be denied certain tax benefits (i.e., accelerated cost recovery deductions on utility property) for periods during which the energy tax was not passed through to end users.

Effective Date

The tax would be imposed at one-third of the full rates beginning July 1, 1994, and at two-thirds of the full rates beginning July 1, 1995. The full rates would apply beginning July 1, 1996.

Floor stocks taxes would be imposed on taxable products held beyond the point of collection on July 1, 1994, and on the date of each subsequent rate change (including each annual indexing change).

2. Extend the current 2.5-cents-per-gallon motor fuels excise tax rate; transfer revenues to the Highway Trust Fund

Present Law

The Federal motor fuels excise tax generally is imposed on motor fuels (gasoline, special motor fuels, and diesel fuel) used for highway transportation, gasoline and special motor fuels used in motorboats, and diesel fuels used in trains. Off-highway business uses generally are exempt from motor fuels taxes as are sales for export, for the exclusive use of State and local governments and nonprofit educational organizations, and for certain other uses.

The rate of tax on motor fuels is 14.1 cents per gallon on gasoline and special motor fuels and 20.1 cents per gallon on diesel fuel and includes a "deficit reduction rate" (General Fund rate) of 2.5 cents per gallon. The deficit reduction rate also is imposed on diesel fuel used in trains. The deficit reduction rate does not apply after September 30, 1995. Revenues from the deficit reduction rate are retained in the General Fund, while the balance of the highway motor fuels tax revenues are transferred to the Highway Trust Fund through September 30, 1999.

Administration's Proposal

The proposal would extend the additional 2.5-cents-per-gallon motor fuels tax rate from October 1, 1995 through September 30, 1999; these revenues generally would be transferred into the Highway Trust Fund with revenues equivalent to 2-cents-per-gallon credited to the Highway Account and one-half-cent-per-gallon to the Mass Transit Account. Revenues from the 2.5-cents-per-gallon tax on diesel used in trains would be retained in the General Fund as would 2.5 cents per gallon of the tax on motorboat, small-engine, and nonhighway recreational fuels. The proposal would retain present-law motor fuels tax exemptions.

Effective Date

The extension of the 2.5-cents-per-gallon rate would apply after September 30, 1995.

3. Increase inland waterways fuel tax

Present Law

A Federal inland waterway fuel tax is imposed on diesel and other liquid fuels used by commercial cargo vessels on specified inland or intracoastal waterways of the United States (sec. 4042). Receipts from these tax are transferred to the Inland Waterways Trust Fund (sec. 9506).

The tax rate on these fuels is 17 cents per gallon for 1993, 19 cents per gallon for 1994, and 20 cents per gallon for 1995 and thereafter. In addition, there is a 0.1-cent-per-gallon tax on such fuels for the Leaking Underground Storage Tank Trust Fund (sec. 9508).

Administration's Proposal

The proposal would increase the Federal inland waterway fuel tax by $1.00 per gallon in a series of steps. Under the proposal, inland waterways fuel would be taxed at a rate of 29 cents per gallon in 1994, 60 cents per gallon in 1995, 90 cents in 1996, and $1.20 per gallon in all years thereafter. The proposal does not change the additional 0.1-cent-per-gallon fuel tax.

Effective Date

The proposal would be effective beginning in 1994.

E. Compliance Provisions

1. Reporting rule for service payments to corporations

Present Law

A person engaged in a trade or business who makes payments during the calendar year of $600 or more to a person for services performed must file an information return with the Internal Revenue Service ("IRS") reporting the amount of such payments, as well as the name, address and identification number of the person to whom such payments were made. A similar statement must also be furnished to the person to whom such payments were made. Treasury regulations generally provide, however, that payments to corporations (including payments for services) need not be reported (Treas. Reg. sec. 1.6041-3(c); Prop. Treas. Reg. sec. 1.6041A-1(d)(2)).[1]

Administration's Proposal

The proposal would provide that payments for services purchased in the course of the payor's trade or business will not be exempt from the information reporting requirements merely because the payments are made to a corporation.

Effective Date

The proposal would apply to payments for services made by a payor after December 31, 1993.

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[1] In general, information returns are required regarding payments to a corporation engaged in providing medical and health care services or engaged in billing and collecting payments with respect to medical and health care services.

2. Raise standard for accuracy-related and preparer penalties

Present Law

A 20-percent penalty is imposed on any portion of an underpayment of tax that is attributable either to a substantial understatement of income tax on a return, or to negligence or disregard of rules or regulations (sec. 6662).

For this purpose, an understatement[1] is "substantial" if it exceeds the greater of 10 percent of the tax required to be shown on the year's return or $5,000 ($10,000 for corporations other than S corporations and personal holding companies). In determining whether an understatement is substantial, the amount of the understatement is reduced by any portion attributable to an item if (1) the treatment of the item on the return is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed on the tax return (or a statement attached to the return), provided that the item or treatment disclosed was not "frivolous" (Treas. Reg. sec. 1.6662-4)). Special rules apply to tax shelters.

The term "negligence" includes any failure to make a reasonable attempt to comply with the internal revenue laws, a failure to exercise ordinary and reasonable care in the preparation of a tax return, and a failure to keep adequate books and records or to substantiate items properly (Treas. Reg. sec. 1.6662-3(b)(1)). The term "disregard" includes any careless, reckless, or intentional disregard of rules or regulations (sec. 6662(c)). The penalty for negligence or disregard of rules or regulations does not apply where the position taken is adequately disclosed, the position is not "frivolous", and the taxpayer has adequate books and records and has substantiated items properly (Treas. Reg. sec. 1.6662-3(c)).[2]

A $250 penalty with respect to a return or claim for refund of income tax may be imposed on a preparer if any understatement of tax liability on the return or claim for refund resulted from a position that did not have a realistic possibility of being sustained on its merits and the preparer knew or reasonably should have known of the position (sec. 6694(a)). The penalty is $1000 per return or claim for refund if the understatement is willful or due to any reckless or intentional disregard of rules or regulations (sec. 6694(b)). These penalties may be avoided where the position taken on the return or claim for refund is adequately

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[1] Generally, an "understatement" of income tax is the excess of the tax required to be shown on the return, over the tax imposed which is shown on the return (reduced by any rebates of tax).

[2] In the case of a position contrary to a regulation, the position taken must also represent a good faith challenge to the validity of the regulation.

disclosed and is not "frivolous" (Treas. Reg. secs. 1.6694-2(c), 1.6694-3(c)(2)).[3]

A "frivolous" position with respect to an item for purposes of all of these penalty provisions is one that is "patently improper" (Treas. Reg. sec. 1.6662-3(b)(3), 1.6662-4(e)(2)(i), 1.6694-2(c)(2), 1.6694-3(c)(2)).

Administration's Proposal

Under the proposal, the "reasonable basis" standard would replace the "not frivolous" standard for purposes of the accuracy-related and income tax return preparer penalties. "Reasonable basis" would be defined as a standard that is significantly higher than "not patently improper." The reasonable basis standard intended by the proposal, therefore, would be a relatively high standard of tax reporting. This standard would not be satisfied by a return position that is merely arguable or that is merely a colorable claim.

As a result of the proposal, a taxpayer could avoid a substantial understatement penalty by adequately disclosing a return position only if the position had at least a reasonable basis. Similarly, a taxpayer could avoid the penalty that applies to disregarding rules or regulations by adequately disclosing a return position only if the position had at least a reasonable basis. A disclosure exception would no longer be necessary to avoid a penalty for negligence, because a taxpayer generally would not be considered to have been negligent with respect to a return position, regardless of whether it was disclosed, if the position had a reasonable basis. Also, as a result of the proposal, a preparer could avoid a penalty by adequately disclosing a return position only if the position had at least a reasonable basis.[4]

Effective Date

The proposal would apply to tax returns due (without regard to extensions) on or after December 31, 1993.

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[3] In the case of a position contrary to a regulation, the position taken must also represent a good faith challenge to the validity of the regulation.

[4] The proposal also would eliminate the reasonable cause and good faith exception for fraud, because fraud is inconsistent with reasonable cause and good faith.

3. Modify tax shelter rules for purposes of the substantial understatement penalty

Present Law

Under present law, a 20-percent penalty applies to any portion of an underpayment of income tax required to be shown on a return that is attributable to a substantial understatement of income tax (sec. 6662)). For this purpose, an understatement is considered "substantial" if it exceeds the greater of (1) 10 percent of the tax required to be shown on the return, or (2) $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company). Generally, the amount of an "understatement" of income tax is the excess of the tax required to be shown on the return, over the tax imposed which is shown on the return (reduced by any rebates of tax).

In determining whether an understatement is substantial, the understatement generally is reduced by the portion of the understatement that is attributable to an item for which there was substantial authority or adequate disclosure (sec. 6662(d)(2)). However, in the case of tax shelter items, the understatement is reduced only by the portion of the understatement that is attributable to an item for which there both was substantial authority and with respect to which the taxpayer reasonably believed that the claimed treatment of the item was more likely than not the proper treatment (sec. 6662(d)(2)(C)(i)). Disclosure made with respect to a tax shelter item does not affect the amount of an understatement.

A "tax shelter" is any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement if the principal purpose of such partnership, entity, plan or arrangement is to avoid or evade Federal income tax (sec. 6662(d)(2)(C)(ii)). An item of income, gain, loss, deduction or credit is a "tax shelter item" if the item is directly or indirectly attributable to the principal purpose of the tax shelter (Treas. Reg. sec. 1.6662-4(g)(3)).

Administration's Proposal

The proposal would tighten the requirements for reducing the amount of an understatement in the case of tax shelter items for purposes of the substantial understatement penalty. Under the proposal, an understatement would be reduced by the portion of the understatement attributable to a tax shelter item only if, in addition to satisfying existing requirements, the taxpayer could demonstrate that the reasonably anticipated after-tax benefits from the taxpayer's investment in the shelter do not significantly exceed the reasonably anticipated pre-tax economic profit from such investment.

Thus, an understatement would be reduced by the portion of the understatement attributable to a tax shelter item only if (1) there

was substantial authority for the treatment of the item claimed on the return, (2) the taxpayer reasonably believed that the claimed treatment was more likely than not the proper treatment, and (3) the reasonably anticipated after-tax benefits from the taxpayer's investment in the shelter do not significantly exceed the reasonably anticipated pre-tax economic profit from such investment.

The proposal does not alter the definition of "tax shelter" for purposes of the substantial understatement penalty and, therefore, applies only to investments in arrangements that are considered tax shelters without regard to this provision.

Effective Date

This proposal would apply to tax returns due (without regard to extensions) on or after December 31, 1993.

4. Use of Harbor Maintenance Trust Fund for administrative expenses

Present Law

Under present law, amounts in the Harbor Maintenance Trust Fund are available, as provided by appropriation Acts, for making expenditures--

(1) under section 210(a) of the Water Resources Development Act of 1986 (Corps of Engineers costs for dredging and maintaining harbors at U.S. ports);

(2) for payments of rebates of certain St. Lawrence Seaway tolls or charges; and

(3) for payment of administrative expenses incurred by the Department of the Treasury in administering the harbor maintenance excise tax (but not more than $5 million per fiscal year) for periods during which no Customs processing fee applies under the Consolidated Omnibus Budget Reconciliation Act of 1985 ("1985 Act").

The Customs processing fee is currently scheduled to expire after September 30, 1995.[1] Thus, since the Customs processing fee is in effect under the 1985 Act, the Trust Fund is not permitted to be used for such Treasury (Customs) administrative expenses.

Administration's Proposal

The proposal would provide up to $5 million per fiscal year from the Harbor Maintenance Trust Fund for the Department of the Treasury (Customs Service) to improve compliance with the existing harbor maintenance excise tax by removing the current Trust Fund restriction against such use.

Effective Date

The proposal would be effective on the date of enactment.

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[1] A separate Administration budget proposal (not described in this document) would permanently extend the current Customs processing fee. (On April 29, 1993, the Ways and Means Subcommittee on Trade approved a provision to extend the current Customs processing fee for three years, through September 30, 1998.)

F. Miscellaneous Revenue-Increase Provisions

1. Substantiation and disclosure requirements for charitable contributions

Present Law

An individual taxpayer who itemizes deductions must separately state (on Schedule A to the Form 1040) the aggregate amount of charitable contributions made by cash or check and the aggregate amount made by donated property other than cash or check.

A taxpayer is not required to provide specific information on his or her return regarding a claimed charitable contribution made by cash or check; nor in such a case is a donee organization required to file an information return with the IRS, regardless of the amount of cash or check involved. However, taxpayers must provide certain information (on Form 8283) if the amount of the claimed contribution for all noncash contributions exceeds $500.[1]

A payment to a charity (regardless of whether it is termed a "contribution") in exchange for which the payor receives an economic benefit is not deductible under section 170, except to the extent that the taxpayer can demonstrate that the payment exceeds the fair-market value of the benefit received from the charity.[2]

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[1] If the claimed deduction for a noncash gift exceeds $5,000 per item or group of similar items (other than certain publicly traded securities), a qualified appraiser must sign the Form 8283, and an authorized representative of the donee charity also must sign the Form 8283, acknowledging receipt of the gift and providing certain other information. In certain situations, information reporting by the donee charity is required if it subsequently disposes of donated property (sec. 6050L).

[2] See Rev. Rul. 67-246, 1967-2 C.B. 104.

Under current IRS practice, certain small items and token benefits (e.g., key chains and bumper stickers) that have insubstantial value are disregarded, such that the full amount of the contribution is deductible. Rev. Proc. 90-12, 1990-1 C.B. 471, provides that tokens or benefits given to the donor in connection with a contribution will be considered to have insubstantial value if (1) the payment occurs in the context of a fundraising campaign in which the charity informs patrons how much of their payment is a deductible contribution, and (2) either (a) the fair-market value of all the benefits received in connection with the payment is not more than two percent of the payment, or $50, whichever is less, or (b) the payment made by the patron is $25 or more (adjusted for inflation) and the only benefits received in connection with the payment are token items (e.g., key chains or mugs) which bear the organization's name or logo and which (in the aggregate) are within

The Internal Revenue Code does not require a tax-exempt organization that is eligible to receive tax-deductible contributions to state explicitly, in its solicitations for support from members or the general public, whether an amount paid to the organization is deductible as a charitable contribution or whether all or part of the payment constitutes consideration for goods or services furnished to the payor.[3] In contrast, tax-exempt organizations that are not eligible to receive tax-deductible contributions are required to state expressly in certain fund-raising solicitations that contributions or gifts to the organization are not deductible as charitable contributions for Federal income tax purposes (sec. 6113).[4] A penalty is imposed on such organizations for failure to comply with the section 6113 disclosure requirement, unless reasonable cause is shown (sec. 6710).

Tax-exempt organizations generally are required to file an annual information return (Form 990) with the IRS. However, churches (and their affiliated organizations), as well as tax-exempt organizations (other than private foundations) that normally have gross receipts in each taxable year of not more than $25,000, are not required to file the Form 990.[5] If a charity is required to file a Form 990, then it must report, among other items, the names and addresses of all persons who contributed, bequeathed, or devised $5,000 or more (in cash or other property) during the taxable year.[6]

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the limits for "low-cost items" under section 513(h)(2). See also Rev. Proc. 92-49, 1992-26 IRB 18 (amplifying Rev. Proc. 90-12, by allowing charities to distribute certain low-cost items to contributors without affecting the deductibility of the contribution).

[3] However, Schedule A to the Form 1040 (and the accompanying instructions) inform taxpayers that if they made a contribution to a charity and received a benefit in return, the value of that benefit must be subtracted in calculating the charitable contribution deduction.

[4] However, the disclosure requirement of section 6113 does not apply to an organization the gross receipts of which in each taxable year are normally not more than $100,000, nor does the disclosure requirement apply to any solicitation made by letter or telephone call if such letter or call is not part of a coordinated fundraising campaign soliciting more than 10 persons during the calendar year (sec. 6113(b)(2)(A) and (c)(2)).

[5] See section 6033(a)(2) and Rev. Proc. 83-23, 1983-1 C.B. 687.

[6] See section 6033(b)(5) and Treas. Reg. sec. 1.6033-2(a)(2)(ii)(f).

Administration's Proposal

The proposal would incorporate certain items from H.R. 11 (the Revenue Act of 1992), including the substantiation and disclosure requirements relating to charitable contributions.

H.R. 11, as passed by the Congress in 1992 and vetoed by President Bush, included the following two provisions that would require substantiation and disclosure relating to charitable contributions:

(1) Substantiation requirement.--Section 170 would be amended to provide that no deduction is allowed under that section for any contribution of $750 or more[7] unless the taxpayer has written substantiation from the donee organization of the contribution (including a good faith estimate of the value of any good or service that has been provided to the donor in exchange for making the gift to the donee).[8]

This provision would not impose an information reporting requirement upon charities; rather, it would place the responsibility upon taxpayers who claim an itemized deduction for a contribution of $750 or more to request (and maintain in their records) substantiation from the charity of their contribution (and any good or service received in exchange).[9] Taxpayers could not rely solely on a canceled check as substantiation for a donation in excess of $750.

Under the proposal, the substantiation must be obtained by the taxpayer prior to filing his or her return for the taxable year in which the contribution was made (or if earlier, the due date, including extensions, for such return). Substantiation would not be required if the donee organization files a return with the IRS

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[7] Separate payments would generally be treated as separate contributions and would not be aggregated for the purposes of applying the $750 threshold. In cases of contributions paid by withholding from wages, the deductions from each paycheck would be treated as separate payments.

[8] If the donee organization provided no goods or services to the taxpayer in consideration of the taxpayer's contribution, the written substantiation must include a statement to that effect.

[9] In the case where a taxpayer makes a noncash contribution claimed to be worth more than $750, the taxpayer would be required to obtain from the charity a receipt that describes the donated property (and indicates whether any good or service was given to the taxpayer in exchange), but the charity would not be required to value the property it receives from the donor.

(in accordance with Treasury regulations) reporting information sufficient to substantiate the amount of the deductible contribution.

(2) Information disclosure for quid pro quo contributions.--Charitable organizations that receive a quid pro quo contribution (meaning "a payment made partly as a contribution and partly in consideration for goods or services provided to the payor by the donee organization") would be required, in connection with the solicitation or receipt of such a contribution, to (1) inform the donor that the amount of the contribution that is deductible for Federal income tax purposes is limited to the excess of the amount of any money (and the value of any property other than money) contributed by the donor over the value of the goods or services provided by the organization, and (2) provide the donor with a good faith estimate of the value of goods or services furnished to the donor by the organization.

The disclosure requirement would apply to all quid pro quo contributions regardless of the dollar amount of the contribution involved (i.e., even in cases with payments of less than $750), and the disclosure must be made by the charity in connection with either the solicitation or receipt of the contribution.[10] Thus, for example, if a charity receives a $75 contribution from a donor, in exchange for which the donor receives a dinner valued at $40, then the charity must inform the donor that only $35 is deductible as a charitable contribution. However, the proposal would not apply if only de minimis, token goods or services are given to a donor (see Rev. Procs. 90-12 and 92-49, discussed above). Also, the proposal would not apply to transactions that have no donative element (e.g., sales of goods by a museum gift shop that are not, in part, donations).

The proposal also provides that penalties ($10 per contribution, but capped at $5,000 per particular fundraising event or mailing) could be imposed upon charities that fail to make the required disclosure, unless the failure was due to reasonable cause. The penalties would apply if an organization either fails to make any disclosure in connection with a quid pro quo contribution or makes a disclosure that is incomplete or inaccurate (e.g., an estimate not determined in good faith of the value of goods or services furnished to the donor).

Effective Date

The proposal would be effective for contributions made after December 31, 1993.

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[10] Disclosure must be reasonably likely to come to the attention of the donor. For example, a disclosure of the required information in small print set forth within a larger document might not meet the requirement.

2. Expansion of 45-day interest-free period for certain refunds

Present Law

No interest is paid by the Government on a refund arising from an original income tax return if the refund is issued by the 45th day after the later of the due date for the return (determined without regard to any extensions) or the date the return is filed (sec. 6611(e)).

There is no parallel rule for refunds of taxes other than income taxes (i.e., employment, excise, and estate and gift taxes), for refunds of any type of tax arising from amended returns, or for claims for refunds of any type of tax.

If a taxpayer files a timely original return with respect to any type of tax and later files an amended return claiming a refund, and if the IRS determines that the taxpayer is due a refund on the basis of the amended return, the IRS will pay the refund with interest computed from the due date of the original return.

Administration's Proposal

No interest is to be paid by the Government on a refund arising from any type of original tax return if the refund is issued by the 45th day after the later of the due date for the return (determined without regard to any extensions) or the date the return is filed.

A parallel rule applies to amended returns and claims for refunds: if the refund is issued by the 45th day after the date the amended return or claim for refund is filed, no interest is to be paid by the Government for that period of up to 45 days (interest would continue to be paid for the period from the due date of the return to the date the amended return or claim for refund is filed). If the IRS does not issue the refund by the 45th day after the date the amended return or claim for refund is filed, interest would be paid (as under present law) for the period from the due date of the original return to the date the IRS pays the refund.

A parallel rule also applies to IRS-initiated adjustments (whether due to computational adjustments or audit adjustments). With respect to these adjustments, the IRS is to pay interest for 45 fewer days than it otherwise would.

Effective Date

The extension of the 45-day processing rule would be effective for returns required to be filed (without regard to extensions) on or after January 1, 1994. The amended return rule would be effective for amended returns and claims for refunds filed on or after January 1, 1995 (regardless of the taxable

period to which they relate). The rule relating to IRS-initiated adjustments would apply to refunds paid on or after January 1, 1995 (regardless of the taxable period to which they relate).

3. Deny deductions relating to travel expenses paid or incurred in connection with travel of taxpayer's spouse or dependents

Present Law

In general, a taxpayer is permitted a deduction for all ordinary and necessary expenses paid or incurred during the taxable year (1) in carrying on any trade or business and (2) in the case of an individual, for the production of income. Such deductible expenses may include reasonable travel expenses paid or incurred while away from home, such as transportation costs and the cost of meals and lodging.

In the case of ordinary and necessary business expenses, if a taxpayer travels to a destination and while at that destination engages in both business and personal activities, travel expenses to and from such destination are deductible only if the trip is related primarily to the taxpayer's trade or business. If the trip is primarily personal in nature, expenses while at the destination that are properly allocable to the taxpayer's trade or business are deductible even though the traveling expenses to and from the destination are not deductible (Treas. reg. sec. 1.162-2(b)(1)).

Under Treasury regulations, if the taxpayer's spouse accompanies the taxpayer on a business trip, expenses attributable to the spouse's travel are not deductible unless it is adequately shown that the spouse's presence on the trip has a bona fide business purpose (Treas. reg. sec. 1.162-2(c)). The performance of some incidental service by the spouse does not cause the expenses to qualify as deductible business expenses. Under the Treasury regulations, the same rules apply to any other members of the taxpayer's family who accompany the taxpayer on such a trip.

In general, business expenses other than unreimbursed employee business expenses may be deducted in computing adjusted gross income (AGI) and are not subject to the 2-percent floor on miscellaneous itemized deductions. Expenses for the production of income other than rental or royalty income are generally deductible as an itemized deduction from AGI (if the activity does not constitute a trade or business) and are subject to the 2-percent floor on miscellaneous itemized deductions.

Gross income does not include the value of a working condition fringe (sec. 132(d)). A "working condition fringe" is any property or service provided to an employee of an employer to the extent that if an employee paid for the property or service, the amount paid would be deductible as an ordinary and necessary business expense (sec. 162) or a depreciation expense (sec. 167).

Administration's Proposal

The proposal would deny a deduction for travel expenses paid or incurred with respect to a spouse, dependent, or other individual accompanying a person on business travel, unless (1) the spouse, dependent, or other individual accompanying the person is a bona fide employee of the person paying or reimbursing the expenses, (2) the travel of the spouse, dependent, or other individual is for a bona fide business purpose, and (3) the expenses of the spouse, dependent, or other individual would otherwise be deductible. No inference is intended as to the deductibility of these expenses under present law. The proposal would not deny a deduction for expenses that would otherwise qualify as deductible moving expenses.

Effective Date

The proposal would be effective for amounts paid or incurred after December 31, 1993.

4. Increase withholding rate on supplemental wage payments

Present Law

Under Treasury regulations, withholding on supplemental wage payments (such as bonuses, commissions, and overtime pay) that are not paid concurrently with wages (or that are paid concurrently with wages, but are separately stated) for a payroll period may be done at a rate of 20 percent (at the employer's election) (Treas. reg. sec. 31.3402(g)-1).

Administration's Proposal

The proposal would increase the applicable withholding rate on supplemental wage payments to 28 percent.

Effective Date

The proposal would be effective for payments made after December 31, 1993.

G. Other Provisions

1. Access to tax information by the Department of Veterans Affairs

Present Law

The Internal Revenue Code prohibits disclosure of tax returns and return information of taxpayers, except for disclosure to certain Governmental entities in certain enumerated instances (sec. 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431).

Among the disclosures permitted under the Code is disclosure to the Department of Veterans Affairs ("DVA") of self-employment tax information and certain tax information supplied to the Internal Revenue Service and Social Security Administration by third parties. Disclosure is permitted to assist DVA in determining eligibility for, and establishing correct benefit amounts under, certain of its needs-based pension and other programs (sec. 6103(l)(7)(D)(viii)). The income tax returns filed by the veterans themselves are not disclosed to DVA.

The DVA is required to comply with the safeguards presently contained in the Code and in section 1137(c) of the Social Security Act (governing the use of disclosed tax information). These safeguards include independent verification of tax data, notification to the individual concerned, and the opportunity to contest agency findings based on such information.

The DVA disclosure provision is scheduled to expire after September 30, 1997.

Administration's Proposal

The proposal would permanently extend the authority to disclose tax information to the DVA.

Effective Date

The proposal would apply after September 30, 1997.

2. Access to tax information by the Department of Housing and Urban Development

Present Law

The Internal Revenue Code prohibits disclosure of tax returns and return information of taxpayers, except for disclosure to certain Governmental entities in certain enumerated instances (sec. 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431). Any authorized recipient of return information must maintain a system of safeguards to protect against unauthorized disclosure of the information.

Administration's Proposal

The proposal would permit disclosure of certain tax return information to the Department of Housing and Urban Development (HUD) to assist HUD in verifying eligibility for certain HUD programs. Such tax return disclosure would be permitted only with respect to applicants for and participants in HUD programs who have executed consent forms under section 904(b)(3) of the Stewart B. McKinney Homeless Assistance Amendments Act of 1988.

Under the proposal, HUD would be required to comply with the safeguards presently contained in the Code (governing the use of disclosed tax information).

Effective Date

The proposal would be effective on the date of enactment.

3. Access to tax information by the Health Care Financing Administration

See page 57 of the Subcommittee on Health's markup document entitled "Amendments Relating to Part A of the Medicare Program."

4. BATF user fees for processing applications for alcohol certificates of label approval

Present Law

The Treasury Department's Bureau of Alcohol, Tobacco, and Firearms (BATF) is required to approve all alcoholic beverage labels and conduct various laboratory analyses to assure compliance with the Federal Alcohol Administration Act (27 U.S.C., Chapter 8) and the Internal Revenue Code and regulations. There is currently no charge or fee for these BATF services.

Under the Internal Revenue Code, annual alcohol occupational excise taxes are imposed as follows:

Producers of distilled spirits, wines or beer (secs. 5081, 5091)	$1,000 per year per premise[1]
Wholesale dealers of liquors, wines or beer (sec. 5121)	$500 per year
Retail dealers in liquors, wines or beer (sec. 5121)	$250 per year
Nonbeverage use of distilled spirits (sec. 5131)	$500 per year
Industrial use of distilled spirits (sec. 5276)	$250 per year

These annual alcohol occupational tax rates are as enacted in the Omnibus Budget Reconciliation Act of 1987 (P.L. 100-203, "1987 Act"), effective on January 1, 1988.[2] The 1987 Act increased the wholesale and retail alcohol occupational taxes and imposed new occupational taxes on distilled spirits, wine and beer producers as well as for industrial users of distilled spirits.

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[1] Tax is $500 per year per premise for businesses with gross receipts of less than $500,000 in the preceding taxable year.

[2] The increased and new alcohol occupational taxes under the 1987 Act were enacted in lieu of the Reagan Administration's proposed alcohol labeling and processing fees, which were included in the fiscal year 1988 budget proposal.

Administration's Proposal[3]

The Administration proposes to establish BATF user fees for the processing of applications for certificates of alcohol label approval (or exemptions therefrom) required by the Federal Alcohol Administration Act and formula (and statement of process) reviews or laboratory tests and analyses performed under that Act and the Internal Revenue Code and regulations.

The Secretary of the Treasury would be authorized to implement the user fee program and to establish fee rates: not less than $50 for each application and not less than $250 for each formula (and statement of process) review or test and analysis. No specific maximum fee amounts are stated. Up to $5 million of the fees under the proposal are to be retained and used by BATF for offsetting the cost of BATF's Compliance Alcohol Program; any fees collected in excess of $5 million per year are to be deposited in the Treasury as miscellaneous receipts.

Effective Date

The proposal would be effective for applications filed and for formula (and statement of process) reviews or tests and analyses initiated 90 days from the date of enactment.

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[3] The Administration's current proposal is included in the proposed Treasury Department's appropriation for fiscal year 1994.

5. Excise tax on certain vaccines for the Vaccine Injury Compensation Trust Fund

Present Law

Vaccine compensation program

The Vaccine Injury Compensation Trust Fund ("Vaccine Trust Fund") provides a source of revenue to compensate individuals who die or who are injured as a result of the administration of certain vaccines: diphtheria, pertussis, and tetanus ("DPT"); diphtheria and tetanus ("DT"); measles, mumps, and rubella ("MMR"); and polio.

All persons who were immunized with a covered vaccine after October 1, 1988, and before October 1, 1992, are prohibited from commencing a civil action in State court for vaccine-related damages unless they first file a petition with the United States Claims Court, where such petitions are assigned to a special master and governed by streamlined procedural rules designed to expedite the proceedings.[1] Only if the final settlement under the Program is rejected may the claimant proceed with a civil tort action in the appropriate State court, where recovery generally will be governed by State tort law principals.

Vaccine excise tax

The Vaccine Trust Fund is funded by a manufacturer's excise tax on DPT, DT, MMR, and polio vaccines (and any other vaccines used to prevent these diseases). The excise tax per does is $4.56 for DPT, $0.06 for DT, $4.44 for MMR, and $0.29 for polio vaccines.

The vaccine excise tax expired after December 31, 1992. Amounts in the Vaccine Trust Fund are available for the payment of compensation under the Program with respect to vaccines administered after September 30, 1988, and before October 1, 1992.

Administration's Proposal

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[1] Persons who received vaccines before the Program's effective date of october 1, 1988 ("retrospective cases") also may be eligible for compensation under the Program if they had not yet received compensation and elected to file a petition with the United States Claims Court on or before January 31, 1991. Under the Program, awards in retrospective cases are somewhat limited compared to "prospective cases" (i.e., those where the vaccine was administered on or after October 1, 1988). Awards in retrospective cases are not paid out of the Vaccine Trust Fund but are paid out of funds specially authorized by Congress. See 42 U.S.C. sec. 300aa-15(i), (j) (appropriating $80 million for fiscal year 1989 and for each subsequent year).

The proposal would make the Vaccine Compensation Trust Fund program and vaccine excise tax permanent.

Effective Date

The extension of coverage under the vaccine compensation program would be effective from October 1, 1992.

The extension of the vaccine excise tax would be effective on April 1, 1993(?).

II. REVENUE-REDUCTION PROVISIONS

A. Training and Education Provisions

1. Permanent extension of employer-provided educational assistance

Present Law

Prior to July 1, 1992, an employee's gross income and wages for income and employment tax purposes did not include amounts paid or incurred by the employer for educational assistance provided to the employee if such amounts were paid or incurred pursuant to an educational assistance program that met certain requirements (sec. 127). This exclusion, which expired with respect to amounts paid after June 30, 1992, was limited to $5,250 of educational assistance with respect to an individual during a calendar year.

In the absence of this exclusion, for purposes of income and employment taxes, an employee generally is required to include in income and wages the value of educational assistance provided by an employer to the employee, unless the cost of such assistance qualifies as a deductible job-related expense of the taxpayer.

Administration's Proposal

The proposal would retroactively and permanently extend the exclusion for employer-provided educational assistance.

The proposal would include a number of transition rules to deal with cases in which employers provided educational assistance to employees between July 1, 1992, and December 31, 1992.

First, no interest, penalty, or addition to tax would be imposed on employers or employees who continued to exclude from income educational assistance payments made after June 30, 1992.

Second, if an employer included educational assistance payments made after June 30, 1992, in its employees' income and wages (for purposes of income or employment taxes) the amount included is deducted from wages paid in 1993 rather than requiring the taxpayers to file a request for refund for 1992. Under this rule, if an employee receives income and wages from the employer between the date of enactment and December 31, 1993, in an amount at least equal to the amount of educational assistance provided to such employee between July 1, 1992, and December 31, 1992, then the employee's income and wages for the purposes of income and employment taxes for 1993 would be reduced by such amount of educational assistance. The reduction for income and employment tax purposes would be carried out separately with respect to each tax. For purposes of information reports or tax returns, the employer would be required to report

separately the amount of any such income reduction for an employee as nontaxable income. This special rule would not apply if the employer has actual knowledge that the employee treated the educational assistance as excludable from income. Of course, even if the special rule does apply, if the employee treated educational assistance as nontaxable in 1992 the employee would not be able to exclude such amount from income again in 1993.

Amounts reduced from income and wages under this rule would not affect other provisions, for example, the amount that could otherwise be excluded from income as educational assistance in 1993 would not be reduced, nor would the amount of compensation used in determining whether retirement plans of the employer satisfy the tax-qualification requirements of the Code.

If an employer included educational assistance payments made after June 30, 1992, in an employee's income and wages (for purposes of income or employment taxes) and the employee does not receive income and wages from that employer between the date of enactment and December 31, 1993, at least equal to the amount of such educational assistance included in income in 1992, then the employee may seek refund of excess employment taxes in accordance with existing rules. In such a case, the employer would be required to provide a corrected Form W-2 to the employee.

The proposal would also clarify the present-law rule under which educational assistance that does not satisfy section 127 may be excluded from income if and only if it meets the requirements of a working condition fringe benefit.

Effective Date

The extension of the exclusion would be effective for taxable years ending after June 30, 1992. The clarification to the working condition fringe benefit rule would be effective for taxable years beginning after December 31, 1988.

2. Permanent extension of targeted jobs tax credit and expansion to include approved school-to-work program

Present Law

Tax credit

The targeted jobs tax credit is available on an elective basis for hiring individuals from several targeted groups. The targeted groups consist of individuals who are either recipients of payments under means-tested transfer programs, economically disadvantaged, or disabled.

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

The credit expired for individuals who began work for an employer after June 30, 1992.

Certification of members of targeted groups

Generally an individual is not treated as a member of a targeted group unless certain certification conditions are satisfied. On or before the day on which the individual begins work for the employer, the employer has to have received or have requested in writing from the designated local agency certification that the individual is a member of a targeted group. In the case of a certification of an economically disadvantaged youth participating in a cooperative education program, this requirement is satisfied if necessary certification is requested or received from the participating school on or before the day on which the individual begins work for the employer.

The deadline for requesting certification of targeted group membership is extended until five days after the day the individual begins work for the employer, provided that, on or before the day the individual begins work, the individual has received a written preliminary determination of targeted group eligibility (a "voucher") from the designated local agency (or other agency or organization designated pursuant to a written agreement with the designated local agency). The "designated local agency" is the State employment security agency.

Authorization of appropriations

Present law authorized appropriations for administrative and publicity expenses relating to the credit through June 30, 1992. These monies are to be used by the Internal Revenue Service and the Department of Labor to inform employers of the credit

program.

Administration's Proposal

The proposal would permanently and retroactively extend the targeted jobs tax credit for individuals who begin work for the employer after June 30, 1992. In addition, the targeted jobs tax credit would be expanded to include qualified participants in an approved school-to-work program beginning work after December 31, 1993.

A qualified participant in an approved school-to-work program would be any individual aged 16 through 20 who was enrolled in an approved school-to-work program and certified to be making satisfactory progress in completing the program. A program would be considered to be an approved school-to-work program only if it is a planned program of structured job training designed to integrate academic instruction and work-based learning and is approved by the Secretaries of Labor and Education.

The total number of qualified participants in an approved school-to-work program would be capped in each calendar year. The cap would be as follows: 125,000 in 1994, 140,000 in 1995, 160,000 in 1996, 180,000 in 1997 and 200,000 in 1998 and each year thereafter. These amounts will be allocated among the States in proportion to the number of eligible participants that are estimated to be served in approved school-to-work programs for that year. Such estimates shall be published by the Secretaries of Labor and Education before the beginning of the year to which the allocation applies. Each State's allocation, in turn, will be allocated among its approved school-to-work programs in such manner as the Secretaries of Labor and Education prescribe. Because the approved school-to-work program is a work-study program, the credit would equal 40 percent of up to $3,000 of first-year wages, for a maximum credit of $1,200.

Effective Date

The extension of the basic targeted jobs tax credit would be effective for individuals who begin work for the employer after June 30, 1992. The targeted jobs tax credit would be expanded to include qualified participants in an approved school-to-work program beginning work after December 31, 1993.

B. Investment Incentives

1. Investment tax credits

Present and Prior Law

In general, there is no investment tax credit under present law since the Tax Reform Act of 1986 (1986 Act) repealed the "regular" investment tax credit.

Prior to the 1986 Act, the regular investment credit was a credit against tax liability for up to 10 percent of a taxpayer's investment in new "section 38 property." Section 38 property generally included any tangible personal property and other tangible property (not including a building or its structural components) used as an integral part of manufacturing, production, or extraction, or for furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services. Under regulations, a structure (a "single purpose structure") that housed property used as an integral part of one of the above-specified activities did not constitute a building if the use of the structure was so closely related to the use of the property that the structure could clearly expect to be replaced when the property it housed was replaced. The credit also was available for up to $125,000 of the taxpayer's cost of used property placed in service during a taxable year.

The amount of the credit was based on the Accelerated Cost Recovery System (ACRS) recovery period to which the property was assigned. The 10-percent credit was allowed for 5-year property, 10-year property, and 15-year public utility property. The credit was limited to 6 percent for 3-year property. The credit was further limited to $675 with respect to a passenger automobile.

Prior law also required that the basis of property taken into account in computing the credit be reduced by all or a portion of the credit. Recapture rules required a taxpayer to increase its tax due if recovery property taken into account in computing the credit was disposed of, or otherwise ceased to be section 38 property, before the close of a specified period. This period was 3 years for 3-year property and 5 years for other property.

The regular investment tax credit was subject to the limitations on the use of the general business credit. Unused credits could be carried back 3 years and forward 15 years from the year in which the credit arose. C corporations also were permitted to offset up to 25 percent of their tentative minimum tax by the regular investment tax credit.

Administration's Proposal

In general

Two separate investment tax credits would be provided -- a

permanent, flat credit for small businesses and a temporary, incremental credit for larger businesses. Property eligible for the credits generally would be the same for both credits.

Rules applicable to both credits

Qualified investment property

The credit would be allowed with respect to qualified investment in regular credit property. "Regular credit property" would be defined as eligible property: (1) to which ACRS applies; (2) which is placed in service after December 3, 1992; and (3) the construction, reconstruction, or erection of which is completed by the taxpayer or which is acquired by the taxpayer if the original use of the property commences with the taxpayer. Thus, used property would not qualify for the credits. In addition, the rules of section 50(b) would apply. Thus, the credits would be limited or denied with respect to property used outside the United States, property used for lodging, and property used by tax exempt entities, governments, or foreign persons.

"Eligible property" generally would be defined as: (1) tangible personal property; (2) other tangible property (not including a building or its structural components), but only if such property (a) is used as an integral part of manufacturing, production, or extraction, or the furnishing of transportation, communications, electrical energy, gas, water, or sewage disposal services; (b) constitutes a research facility used in any of the activities described in (a) above; (c) constitutes a facility used in connection with any of the activities described in (a) above for the bulk storage of fungible commodities (including commodities in a liquid or gaseous state); (3) an elevator or escalator; (4) a storage facility used in connection with the distribution of petroleum or any primary product of petroleum; or (5) a single purpose agricultural or horticultural structure. Eligible property generally would include livestock (other than horses).

The term "building" would generally mean any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide working, office, parking, display, or sales space. The would term include, for example, structures such as apartment houses, factory and office buildings, warehouses, barns, garages, railways or bus stations, and stores. The term also would include any structure constructed by or for a lessee even if the structure must be removed, or ownership of the structure reverts to the lessor, at the termination of the lease. The term "building" would not include a structure which is essentially an item of machinery or equipment. No special exception to the definition of a building would be provided for single purpose structure (other than a single purpose agricultural or horticultural structure). Accordingly, whether such a structure would constitute a building would be determined under the generally applicable rules.

The term "structural component" would include, with respect to a building, property which relates (in whole or in part) to the operation, maintenance, or appearance of the building, and is attached to the building (whether or not permanently attached). Thus, the term would include walls, partitions, floors, ceilings, windows, doors, paneling, tiling, wall-to-wall carpeting, plumbing and plumbing fixtures (such as sinks and bathtubs), electric wiring and lighting fixtures, chimneys, stairs, sprinkler systems, and fire escapes. The term would include an item relating to the operation or maintenance of a building even if the item was designed to accommodate the particular needs of property within the building. Thus, for example, a floor of unusual thickness or strength intended to accommodate the demands of heavy machinery would be a structural component, as would be the electrical system of a building even if the system is larger or more extensive than would be needed to serve the electrical needs of the building alone.

Eligible property would not include: (1) any property to the extent the basis of the property is attributable to qualified rehabilitation expenditures; (2) any energy property; (3) any property to the extent the basis of the property is attributable to qualified enhanced oil recovery costs; (4) any qualified electric vehicle; or (5) an air conditioning or heating unit (including all system components, such as motors, compressors, pipes and ducts, etc.). Public utility property would be subject to normalization rules in order to be eligible for the credit. The basis of any property would not include any portion of any basis attributable to a qualified withdrawal from a Merchant Marine capital construction fund.

For purposes of determining the amount of qualified investment eligible for the credits, the basis of regular credit property placed in service would be multiplied by an applicable percentage, depending on the property's recovery period. For 3-year property, (as defined by sec. 168(e)), the applicable percentage would be 33 percent. For 5-year property, the applicable percentage would be 67 percent. For 7-year property, the applicable percentage would be 80 percent. The applicable percentage for property with a recovery period in excess of 7 years would be 100 percent.

Leases

Special rules would apply for property subject to a lease. Property subject to a qualified short-term lease would be taken into account by the lessor. A "qualified short-term lease" would be defined as any lease the term of which is less than one year and which is made in connection with the active conduct by the lessor of a qualified leasing trade or business. A "qualified leasing trade or business" would mean any trade or business that normally derives 80 percent or more of its gross receipts from leases of tangible personal property with terms of less than 30 days.

Property subject to a lease with a term of three years or more

would be taken into account by the lessee, if the original use of the property begins with the lessee. For this purpose, the basis of the property would be its fair market value at the beginning of the lease. For purposes of determining the applicable percentage, the recovery period would be the shorter of: (1) the recovery period of the type of property subject to the lease or (2) the lease term.

Property subject to a lease not described above would not qualify for the credits. Special rules would be provided for options to renew, successive leases, leases between related parties, and early lease terminations.

Other rules

The credits generally would be treated as part of the section 38 general business credit and, therefore, would be subject to present-law limitations on use of that credit. The credits could be used by any taxpayer to offset up to 25 percent of the tentative minimum tax. As under present law, any unused general business credit could be carried back 3 years and forward 15 years, although no carryback of the investment credits would be permitted to years prior to the effective date of the proposal. Other limitations applicable to the use of general business credits, such as the passive loss limitations and at risk rules, would apply to the credits.

An estate, trust, regulated investment company (RIC), real estate investment trust (REIT), real estate mortgage investment conduit (REMIC), or common trust fund would not be eligible to claim either of the credits.

Small business investment tax credit

The small business investment tax credit would be a permanent credit. The allowable amount of credit would be 5 percent of the amount of qualified investment of regular credit property of an eligible small business (7 percent for property placed in service after December 3, 1992, and on or before December 31, 1994).

An "eligible small business" generally would be defined as a business with average annual gross receipts of less than $5 million in the three years immediately preceding the taxable year, using principles similar to those provided for determining whether corporations may use the cash method of accounting under section 448.

The aggregate basis of regular credit property that would be taken into account by an eligible small business could not exceed $250,000. If the limitation is exceeded, the $250,000 amount would be spread, pro rata, among all regular credit property placed in service by the taxpayer during the year. The $250,000 amount would be reduced for taxable years that are less than 12 months or that include any period before December 4, 1992. In the case of a

calendar year taxpayer, any property placed in service after December 3, 1992 and before January 1, 1993, would be treated as placed in service on January 1, 1993, and the $250,000 limitation would be increased to $270,000 for taxable years beginning January 1, 1993.

In the case of a partnership (or S corporation) the eligible small business limitation and the $250,000 basis limitation would apply at both the entity and the partner (or shareholder) levels.

An eligible small business would not be allowed to claim more than $675 of credit with respect to a passenger automobile (as defined by sec. 280F).

Recapture rules similar to the rules in effect for the investment credit prior to the 1986 Act would apply to early dispositions of property. The taxpayer's depreciable basis would be reduced by the amount of the credit.

For taxable years beginning before 1995, an eligible small business would be allowed to elect to use the incremental investment tax credit in lieu of the small business regular credit.

Incremental investment tax credit

In general

The incremental investment tax credit would be a temporary credit. Taxpayers not qualifying as eligible small businesses could elect to claim the incremental credit.

Computation of incremental credit

For taxable years that include December 31, 1993, or December 31, 1994, taxpayers would be eligible to claim a credit equal to 7 percent of the excess of their qualified net investment for the calendar year over a base amount for the calendar year.

"Qualified net investment" generally would be equal to the excess of the taxpayer's: (1) qualified investment over (2) the applicable percentage of the amounts realized from the disposition of regular credit property that had been taken into account in determining qualified investment. For purposes of determining qualified investment for periods after December 3, 1992, qualified progress expenditure rules similar to rules of section 47(d) would be provided.

The qualified investment taken into account with respect to any passenger automobile would not exceed $9,600. Only 50 percent of the adjusted basis of any international intermodal cargo container of a U.S. person would be taken into account for purposes of determining qualified investment.

The "base amount" generally would equal 80 percent (70 percent

in the case of 1993) of the annual average of the indexed base investment for each of the base period years. A "base period year" would mean any taxable year beginning after December 31, 1988, and before January 1, 1992 (or, at the election of the taxpayer, any taxable year beginning after December 31, 1986, and before January 1, 1992). The "base investment" for any base period year generally would be determined by applying the applicable percentages to each regular credit property placed in service in the base year. For this purpose, regular credit property would include used regular credit property. In determining its base investment, a lessor generally would not include property subject to a lease of 3 or more years and a lessee would not include leased property unless the property had a fair market value of $1,000,000 or more at the beginning of the lease. The base amounts would be indexed for growth in the gross domestic product. In no event would the base amount for 1993 or 1994 exceed 50 percent of the taxpayer's qualified net investment for the year (the "minimum base" rule).

If, for 1993, the taxpayer's base amount exceeds qualified net investment, such excess would reduce the taxpayer's qualified net investment for 1994.

Recapture rules

The taxpayer would be subject to an addition to tax if, for calendar years 1994, 1995, 1996 or 1997, the taxpayer's base amount exceeds its qualified investment. The addition to tax generally would equal the least of: (1) 7 percent of the excess, (2) the balance in the taxpayer's recapture account, or (3) the aggregate amount of the credit used by the taxpayer. The opening balance in the recapture account would be zero and it would be increased as of the close of any taxable year by the amount of credit determined for the year and decreased by the sum of the amount of credit that vests for the year and the amount of credit recaptured. In the case of credit determined for 1993, such credit would vest ratably over the next four calendar years. In the case of credit determined for 1994, such credit would vest ratably over the next three calendar years. Carrybacks and carryovers of the credit, if any, would be properly adjusted to reflect recapture. Special recapture rules would apply to taxpayers subject to the minimum base rule.

Income inclusion

The amount of credit would not reduce the depreciable basis of property. Rather, the taxpayer would include the amount of credit in gross income. In the case of credit determined for 1993, the amount of credit would be included in income ratably over the 4-taxable-year period beginning in 1994. In the case of credit determined for 1994, the amount of credit would be included in income ratably over the 3-taxable-year period beginning in 1995. Gross income would not be increased with respect to recaptured credits.

Other rules

Property that ceases to be regular credit property with respect to a taxpayer would be treated as disposed of at its fair market value at the time of the cessation. Deemed disposition rules would also apply to leased property and qualified progress expenditure property. Transfers by reason of death, transactions to which section 381(a) applies, dispositions to which sections 1031 or 1033 apply, transfers incident to divorce, and certain changes in the form of business generally would not be treated as dispositions.

Rules similar to those of section 41(f) (relating to aggregation, allocations of the credit, and adjustments for acquisitions and dispositions) and (g) (relating to certain pass-through entities) would apply.

Property placed in service (or qualified progress expenditures made) during the period beginning December 4, 1992, and ending December 31, 1992, would be treated as placed in service (or made) on January 1, 1993.

Effective Date

The proposal generally would be effective for qualifying property placed in service after December 3, 1992.

The proposal generally would not apply to any transition property (as defined in sec. 49(e) of the Internal Revenue Code of 1986, as in effect on the date before the date of the enactment of the Revenue Reconciliation Act of 1990), other than for purposes of determining a taxpayer's base amount.

2. Permanent extension of R&E credit

Present Law

The research tax credit provides a 20-percent credit to the extent that a taxpayer's qualified research expenditures for the current year exceed its base amount for that year. The credit expired after June 30, 1992.

The base amount for the current year generally is computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenditures and had gross receipts during each of at least three years from 1984 through 1988, then its "fixed-base percentage" is the ratio that its total qualified research expenditures for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum ratio of .16). All other taxpayers (such as "start-up" firms) are assigned a fixed-base percentage of .03.

In computing the credit, a taxpayer's base amount may not be less than 50 percent of its current-year qualified research expenditures.

Qualified research expenditures eligible for the credit consist of: (1) "in-house" expenses of the taxpayer for research wages and supplies used in research; (2) certain time-sharing costs for computer use in research; and (3) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf. Expenditures attributable to research that is conducted outside the United States do not enter into the credit computation. In addition, the credit is not available for research in the social sciences, arts, or humanities, nor is it available for research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

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

Deductions for expenditures allowed to a taxpayer under section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research credit

determined for the taxable year.[1]

Administration's Proposal

The proposal would permanently and retroactively extend the research tax credit.

The proposal would add a new rule regarding the determination of the fixed-base percentage of start-up companies. Under the proposal, a taxpayer that did not have gross receipts in at least three years during the 1984-1988 period would be assigned a fixed base percentage of .03 for each of its first five taxable years after 1993 in which it incurs qualified research expenditures. The taxpayer's fixed-base percentage for its sixth through tenth taxable years after 1993 in which it incurred qualified research expenditures would be as follows: (1) for the taxpayer's sixth year, its fixed-base percentage would be one-sixth of its ratio of qualified research expenditures to gross receipts for its fourth and fifth years; (2) for its seventh year, its fixed-base percentage would be one-third of its ratio for its fifth and sixth years; (3) for its eighth year, its fixed-base percentage would be one-half of its ratio for its fifth through seventh years; (4) for its ninth year, its fixed-base percentage would be two-thirds of its ratio for its fifth through eighth years; and (5) for its tenth year, its fixed-base percentage would be five-sixths of its ratio for its fifth through ninth years. For subsequent taxable years, the taxpayer's fixed-base percentage would be its actual ratio of qualified research expenditures to gross receipts for five years selected by the taxpayer from its fifth through tenth taxable years.

Effective Date

The proposal would apply to expenditures paid or incurred after June 30, 1992.

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[1] Taxpayers may alternatively elect to claim a reduced research credit amount in lieu of reducing deductions otherwise allowed (sec. 280C(c)(3)).

3. Capital gains exclusion for certain small business stock

Present Law

Gain from the sale or exchange of stock held for more than one year generally is treated as long-term capital gain.

Net capital gain (i.e., long-term capital gain less short-term capital loss) of an individual is taxed at the same rates that apply to ordinary income, subject to a maximum rate of 28 percent.

Administration's Proposal

In general

The proposal generally would permit noncorporate taxpayers who hold qualified small business stock for at least 5 years to exclude 50 percent of the gains realized on the disposition of their stock. The amount of gain eligible for the 50 percent exclusion is limited to the greater of 10 times the investor's basis in the stock or $10 million of gain from stock in that corporation. For purposes of determining the amount of gain eligible for the exclusion, no reduction is to be made for any capital loss, whether from disposition of small business stock or other asset.

Qualified small business stock

In order to qualify as small business stock, the following requirements must be met.

Eligible stock

The stock must be acquired by the taxpayer after December 31, 1992, at the original issuance (directly or through an underwriter) in exchange for money, other property (not including stock) or as compensation for services provided to the corporation (other than services performed as an underwriter of the stock).

In order to prevent the evasion of the requirement that the stock be newly issued, the exclusion does not apply if the issuing corporation purchases stock from the stockholder (or a related person) or redeems significant amounts of its own stock. For purposes of this anti-evasion rule, purchases by persons related to the issuing corporation are treated as purchases by the issuing corporation.

Qualified corporation

The corporation must be a qualified small business as of the date of issuance and during substantially all of the period that the taxpayer holds the stock.

A qualified small business is a subchapter C corporation other than a DISC or former DISC, a corporation with respect to which an election under section 936 is in effect, a regulated investment company, a real estate investment trust, a real estate mortgage investment conduit, or a cooperative. The corporation also cannot own (i) real property the value of which exceeds 10 percent of its total assets or (ii) portfolio stock or securities the value of which exceeds 10 percent of its total assets in excess of liabilities.

Active business

At least 80 percent (by value) of the corporation's assets (including intangible assets) must be used by the corporation in the active conduct of a qualified trade or business. If in connection with any future trade or business, a corporation uses assets in certain start-up activities, research and experimental activities or in-house research activities, the corporation is treated as using such assets in the active conduct of a qualified trade or business.

Assets that are held to meet reasonable working capital needs of the corporation, or are held for investment and are reasonably expected to be used within 2 years to finance future research and experimentation, are treated as used in the active conduct of a trade or business. In addition, certain rights to computer software are treated as assets used in the active conduct of a trade or business.

A qualified trade or business is any trade or business other than those involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any other trade or business where the principal asset of the trade or business is the reputation or skill of 1 or more of its employees. The term also excludes any banking, insurance, financing, investing, or similar business, any farming business (including the business of raising or harvesting trees), any business involving the production or extraction of products for which percentage depletion is allowable, or any business of operating a hotel, motel, restaurant or similar business.

Gross assets

As of the date of issuance, the excess of (1) the amount of cash and the aggregate adjusted bases of other property held by the corporation, over (2) the aggregate amount of indebtedness of the corporation that does not have an original maturity of more than one year (such as short-term payables), cannot exceed $50 million. For these purposes, amounts received in the issuance are taken into account.

If a corporation satisfies the gross assets test as of the

date of issuance but subsequently exceeds the $50 million threshold, stock that otherwise constitutes qualified small business stock would not lose that characterization solely as a result of that subsequent event. If a corporation (or a predecessor corporation) exceeds the $50 million threshold at any time after December 31, 1992, the corporation can never again issue stock that would qualify for the exclusion.

Subsidiaries of issuing corporation

In the case of a corporation that owns at least 50 percent of the vote or value of a subsidiary, the parent corporation is deemed to own its ratable share of the subsidiary's assets, and to be liable for a ratable share of the subsidiary's indebtedness, for purposes of the "qualified corporation," "active business," and "gross assets" tests described above.

Pass-through entities

Gain from the disposition of qualified small business stock by a partnership, S corporation, regulated investment company or common trust fund that is taken into account by a partner, shareholder or participant (other than a C corporation) is eligible for the exclusion, provided that (1) all eligibility requirements with respect to qualified small business stock are met, (2) the stock was held by the entity for more than 5 years, or (3) the partner, shareholder or participant held its interest in the entity beginning on the date the entity acquired the stock and at all times thereafter before the disposition of the stock. In addition, a partner, shareholder, or participant cannot exclude gain received from an entity to the extent that the partner's, shareholder's, or participant's share in the entity's gain exceeded the partner's, shareholder's or participant's interest in the entity at the time the entity acquired the stock.

Certain tax-free and other transfers

If qualified small business stock is transferred by gift or at death, the transferee is treated as having acquired the stock in the same manner as the transferor, and as having held the stock during any continuous period immediately preceding the transfer during which it was held by the transferor. Qualified small business stock also may be distributed by a partnership to one or more of its partners, as long as (1) all eligibility requirements with respect to qualified small business stock are met, and (2) the partner held its interest in the partnership beginning on the date the partnership acquired the stock and at all times thereafter before the disposition of the stock. In addition, a partner cannot treat stock distributed by a partnership as qualified small business stock to the extent that the partner's share of the stock distributed by the partnership exceeded the partner's interest in the partnership at the time the partnership acquired the stock.

Transferees in other cases are not eligible for the exclusion. Thus, for example, if qualified small business stock is transferred to a partnership or corporation and such entity disposes of the stock, any gain from the disposition will not be eligible for the exclusion.

In the case of certain incorporations and reorganizations where qualified small business stock is transferred for other stock, the transferor treats the stock received as qualified small business stock. The holding period of the original stock is added to that of the stock received. However, the amount of gain eligible for the exclusion is limited to the gain accrued as of the date of the incorporation or reorganization.

Special basis rules

If property (other than money or stock) is transferred to a corporation in exchange for its stock, the basis of the stock received is treated as not less than the fair market value of the property exchanged. Thus, only gains that accrue after the transfer are eligible for the exclusion.

Options, nonvested stock, and convertible instruments

Stock acquired by the taxpayer through the exercise of options or warrants, or through the conversion of convertible debt, is treated as acquired at original issue. The determination whether the gross assets test is met is made at the time of exercise or conversion, and the holding period of such stock is treated as beginning at that time.

In the case of convertible preferred stock, the gross assets determination is made at the time the convertible stock is issued, and the holding period of the convertible stock is added to that of the common stock acquired upon conversion.

Stock received in connection with the performance of services is treated as issued by the corporation and acquired by the taxpayer when included in the taxpayer's gross income in accordance with the rules of section 83.

Offsetting short positions

A taxpayer cannot exclude gain from the sale of qualified small business stock if the taxpayer (or a related person) held an offsetting short position with respect to that stock anytime before the 5-year holding period is satisfied. If the taxpayer (or a related person) acquires an offsetting short position with respect to qualified small business stock after the 5-year holding period is satisfied, the taxpayer must elect to treat the acquisition of the offsetting short position as a sale of the qualified small business stock in order to exclude any gain from that stock.

An offsetting short position is defined to be (1) a short sale of property substantially identical to the qualified small business stock (including writing a call option that the holder is more likely than not to exercise or selling the stock for future delivery) or (2) an option to sell substantially identical property at a fixed price.

Capital gains and investment interest

Any gain that is excluded from gross income under the provision is not taken into account in computing long-term capital gain or in applying the capital loss rules of section 1211 and 1212. In addition, the taxable portion of the gain is taxed at a maximum rate of 28 percent.

The amount treated as investment income for purposes of the investment interest limitation does not include any gain that is excluded from gross income under the provision.

Minimum tax

One-half of any excluded gain is treated as a preference for purposes of the alternative minimum tax.

Effective Date

The proposal would apply to stock issued after December 31, 1992.

4. Modify AMT depreciation schedule

Present Law

A taxpayer is subject to an alternative minimum tax (AMT) to the extent that the taxpayer's tentative minimum tax exceeds the taxpayer's regular income tax liability. A taxpayer's tentative minimum tax generally equals 20 percent (24 percent in the case of an individual) of the taxpayer's alternative minimum taxable income in excess of an exemption amount. Alternative minimum taxable income (AMTI) is the taxpayer's taxable income increased by certain tax preferences and adjusted by determining the tax treatment of certain items in a manner which negates the deferral of income resulting from the regular tax treatment of those items.

One of the adjustments which is made to taxable income to arrive at AMTI relates to depreciation. For AMT purposes, depreciation on most personal property to which the modified Accelerated Cost Recovery System (MACRS) adopted in 1986 applies is calculated using the 150-percent declining balance method (switching to straight line in the year necessary to maximize the deduction) over the property's class life. The class lives of MACRS property generally are longer than the recovery periods allowed for regular tax purposes.

For taxable years beginning after 1989, the AMTI of a corporation is increased by an amount equal to 75 percent of the amount by which adjusted current earnings (ACE) of the corporation exceed AMTI (as determined before this adjustment). In general, ACE means AMTI with additional adjustments that generally follow the rules presently applicable to corporations in computing their earnings and profits. For purposes of ACE, depreciation is computed using the straight-line method over the class life of the property. Thus, a corporation generally must make two depreciation calculations for purposes of the AMT--once using the 150 percent declining balance method over the class life and again using the straight-line method over the class life. Taxpayers may elect to use either method for regular tax purposes. If a taxpayer uses the straight-line method for regular tax purposes, it must also use the straight-line method for AMT purposes.

Administration's Proposal

The depreciation component of the ACE adjustment would be eliminated. Taxpayers, including individuals, would compute AMT depreciation by using the 120-percent declining-balance method over the recovery periods applicable for regular tax purposes. The proposal would not apply to property eligible only for the straight-line method for regular tax purposes (e.g., residential and nonresidential real property). Taxpayers would be allowed to elect to use the 120-percent declining-balance method for regular tax purposes.

Effective Date

The proposal would be effective for property placed in service after December 31, 1993.

5. Bonds for high-speed intercity rail facilities

Present Law

High-speed intercity rail facilities qualify for tax-exempt bond financing if trains operating on the facility are reasonably expected to carry passengers and their baggage at average speeds in excess of 150 miles per hour between stations. Such facilities need not be governmentally-owned, but the owner must irrevocably elect not to claim depreciation or any tax credit with respect to bond-financed property.

Twenty-five percent of each bond issue for high-speed intercity rail facilities must receive an allocation from a State private activity bond volume limitation. If facilities are located in two or more States, this requirement must be met on a State-by-State basis for the financing of facilities located in each State.

Administration's Proposal

The proposal would exempt private activity bonds to provide high-speed rail facilities from State private activity bond volume limitations.

Effective Date

The proposal would be effective for bonds issued after December 31, 1993.

6. Permanent extension of qualified small-issue bonds

Present Law

Interest on certain small issues of private activity bonds is excluded from income if at least 95 percent of the bond proceeds is used to finance manufacturing facilities or agricultural land or property for first-time farmers ("qualified small-issue bonds"). Qualified small-issue bonds are issues having an aggregate authorized face amount of $1 million or less. Alternatively, the aggregate face amount of the issue, together with the aggregate amount of certain related capital expenditures during the six-year period beginning three years before the date of the issue and ending three years after that date, may not exceed $10 million. Special limits apply to these bonds for first-time farmers.

Authority to issue qualified small-issue bonds expired after June 30, 1992.

Administration's Proposal

The proposal would permanently extend the authority to issue qualified small-issue bonds.

Effective Date

The proposal would be effective for bonds issued after June 30, 1992.

C. Expansion and Simplification of Earned Income Tax Credit

Present Law

Eligible low-income workers can claim a refundable earned income tax credit (EITC) of up to 18.5 percent of the first $7,750 of earned income for 1993 (19.5 percent for taxpayers with more than one qualifying child). The maximum amount of credit for 1993 is $1,434 ($1,511 for taxpayers with more than one qualifying child).

This maximum credit is reduced by 13.21 percent of earned income (or adjusted gross income, if greater) in excess of $12,200 (13.93 percent for taxpayers with more than one qualifying child). The EITC is totally phased out for workers with earned income (or adjusted gross income, if greater) over $23,050. The maximum amount of earned income on which the EITC may be claimed, and the income threshold for the phaseout of the EITC, are indexed for inflation. Earned income consists of wages, salaries, other employee compensation, and net self-employment income.

Present law provides that the credit rates for the EITC increase in 1994, as shown in the following table.

	One qualifying child--		Two or more qualifying children--	
Year	Credit rate	Phaseout rate	Credit rate	Phaseout rate
1993	18.5	13.21	19.5	13.93
1994 and after	23.0	16.43	25.0	17.86

A supplemental young child credit is available to taxpayers with qualifying children under the age of one year. This young child credit rate is 5 percent and the phase-out rate is 3.57 percent. It is computed on the same income base as the ordinary EITC. The maximum supplemental young child credit for 1993 is $388.

A supplemental health insurance credit is available to taxpayers who provide health insurance coverage for their qualifying children. This health insurance credit rate is 6 percent and the phase-out rate is 4.285 percent. It is computed on the same income base as the ordinary EITC, but the credit claimed cannot exceed the out-of-pocket cost of the health

insurance coverage. In addition, the taxpayer is denied an itemized deduction for medical expenses of qualifying insurance coverage up to the amount of credit claimed. The maximum supplemental health insurance credit for 1993 is $465.

Administration's Proposal

For taxpayers with one qualifying child, the EITC would be increased. For these taxpayers in 1994, the credit rate would be increased to 26.60 percent. The maximum amount of earned income on which the credit could be claimed would be $7,750 and the maximum credit would be $2,062. This maximum credit would be reduced by 16.16 percent of earned income (or adjusted gross income, if greater) in excess of $11,000. The credit would be completely phased out for taxpayers with earned income (or adjusted gross income, if greater) over $23,760. In 1995 and thereafter, the credit rate would be increased to 34.37 percent. The maximum amount of earned income on which the credit could be claimed would be reduced to (an estimated) $6,170. Thus, the maximum credit in 1995 would be approximately $2,120 (which equals the maximum credit available in 1994, adjusted for projected inflation). The phase-out rate would remain the same as in 1994.

For taxpayers with two or more qualifying children, the EITC also would be increased. For these taxpayers in 1994, the credit rate would be increased to 31.59 percent. The maximum amount of earned income on which the credit could be claimed would be $8,500 and the maximum credit would be $2,685. This maximum credit would be reduced by 15.79 percent of earned income (or adjusted gross income, if greater) in excess of $11,000. Thus, in 1994, the credit would be completely phased out for taxpayers with earned income (or adjusted gross income, if greater) over $28,000. In 1995 and thereafter, the credit rate would be increased to 39.66 percent. The maximum amount of earned income on which the credit could be claimed is expected to be approximately $8,730 in 1995 (which equals the 1994 level, adjusted for projected inflation). Thus, the maximum credit in 1995 is expected to be approximately $3,460. The phase-out rate for 1995 and thereafter would be 19.83 percent.

The EITC would also be extended to low-income workers who (1) do not have any qualifying children (including workers with children who are not qualifying children with respect to that worker); (2) are age 22 or older; and (3) who may not be claimed as a dependent on another taxpayer's return. For these taxpayers, the EITC would be 7.65 percent of the first $4,000 of earned income (for a maximum credit of $306 in 1994). The maximum credit would be reduced by 7.65 percent of earned income (or adjusted gross income, if greater) above $5,000. In 1994 the credit would be completely phased out for taxpayers with earned income (or adjusted gross income, if greater) over $9,000. This credit would not be available on an advance payment basis.

As under present law, all dollar thresholds for years after 1994 would be indexed for inflation.

The supplemental young child credit and the supplemental health insurance credit would be repealed.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1993.

D. Real Estate Investment Provisions

1. Permanent extension of qualified mortgage bonds and mortgage credit certificates

Present Law

Qualified mortgage bonds

Qualified mortgage bonds ("QMBs") are bonds the proceeds of which are used to finance the purchase, or qualifying rehabilitation or improvement, of single-family, owner-occupied residences located within the jurisdiction of the issuer of the bonds (sec. 143). Persons receiving QMB loans must satisfy a home purchase price, borrower income, first-time homebuyer, and other requirements. Part or all of the interest subsidy provided by QMBs is recaptured if the borrower experiences substantial increases in income and disposes of the subsidized residence within nine years after purchase.

Mortgage credit certificates

Qualified governmental units may elect to exchange QMB authority for authority to issue mortgage credit certificates ("MCCs") (sec. 25). MCCs entitle homebuyers to nonrefundable income tax credits for a specified percentage of interest paid on mortgage loans on their principal residences. Once issued, an MCC remains in effect as long as the loan remains outstanding and the residence being financed continues to be the certificate-recipient's principal residence. MCCs are subject to the same targeting requirements as QMBs.

Expiration

Authority to issue QMBs and to elect to trade in bond volume authority to issue MCCs expired after June 30, 1992.

Administration's Proposal

The proposal would permanently extend the authority to issue QMBs and to elect to trade in private activity bond volume limit for authority to issue MCCs.

Effective Date

The extension of the QMB and MCC programs would be effective after June 30, 1992.

2. Permanent extension of the tax credit for low-income rental housing

Present Law

A tax credit is allowed in annual installments over ten years for qualifying newly constructed or substantially rehabilitated low-income rental housing. For most qualifying housing, the credit has a present value of 70 percent of the qualified basis of the low-income housing units. For housing also receiving other Federal subsidies (e.g., tax-exempt bond financing) and for the acquisition cost (e.g., costs other than rehabilitation expenditures) of existing housing that is substantially rehabilitated, the credit has a present value of 30 percent of qualified costs.

The credit amount is based on the qualified basis of the housing units serving the low-income tenants. A residential rental project will qualify for the credit only if (1) 20 percent or more of the aggregate residential rental units in the project are occupied by individuals with 50 percent or less of area median income, or (2) 40 percent or more of the aggregate residential rental units in the project are occupied by individuals with 60 percent or less of area median income. These income figures are adjusted for family size. The low income set-aside is elected when the project is placed in service.

Maximum rents that may be charged families in units on which a credit is claimed depend on the number of bedrooms in the unit. The rent limitation is 30 percent of the qualifying income of a family deemed to have a size of 1.5 persons per bedroom (e.g., a two-bedroom unit has a rent limitation based on the qualifying income for a family of three).

To qualify for the credit, a building owner generally must receive a low-income housing credit allocation from the appropriate State credit authority. An exception is provided for property which is substantially financed with the proceeds of tax-exempt bonds subject to the State's private-activity bond volume limitation. The annual credit ceiling for each State is $1.25 per resident per year.

The low-income housing credit expired after June 30, 1992.

Administration's Proposal

The proposal would permanently extend the low-income housing tax credit.

Effective Date

The proposal would be effective after June 30, 1992.

3. Modify passive loss rules for certain real estate persons

Present Law

The passive loss rules limit deductions and credits from passive trade or business activities. Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income, such as wages, portfolio income, or business income that is not derived from a passive activity. A similar rule applies with respect to credits from passive activities. Deductions and credits suspended under these rules are carried forward to the next taxable year, and are allowed in full when the taxpayer disposes of his entire interest in the passive activity to an unrelated person. The passive loss rules apply to individuals, estates and trusts, and in modified form to closely held C corporations.

Passive activities are defined to include trade or business activities in which the taxpayer does not materially participate. Rental activities (including rental real estate activities) are also treated as passive activities, regardless of the level of the taxpayer's participation. A special exception to this treatment of rental activities permits a taxpayer to treat up to $25,000 of rental real estate losses as nonpassive; this special exception is phased out ratably as taxpayers' adjusted gross incomes increase from $100,000 to $150,000.

Administration's Proposal

The proposal would provide a special rule for real estate professionals. This rule would allow an eligible taxpayer to deduct the net loss for the taxable year from rental real estate activities in which he materially participates (or, if less, the passive activity loss for the year). The deductible loss would be limited, however, to the lesser of (1) the taxpayer's net income from nonpassive real property trade or business activities, or (2) the taxpayer's taxable income (determined without regard to the special rule for real estate professionals). Losses allowed by reason of the current-law $25,000 allowance would be determined before the application of the special rule for real estate professionals. Similar relief would be provided with respect to credits.

A taxpayer would meet the eligibility requirements for the special rule if more than half of the personal services the taxpayer performs in a trade or business during the taxable year are in real property trades or businesses in which he materially participates. A real property trade or business is any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. For purposes of the eligibility requirements, personal services performed as an employee would not be treated as performed in a

real property trade or business unless the person performing the services has more than a 5-percent ownership interest in the employer. In addition, the special rule would not apply to closely held C corporations.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1993.

4. Changes relating to real estate investments by pension funds and others

a. Modification of the rules related to debt-financed income

Present Law

In general, a qualified pension trust or an organization that is otherwise exempt from Federal income tax is taxed on income from a trade or business that is unrelated to the organization's exempt purposes (Unrelated Business Taxable Income or "UBTI") (sec. 511). Certain types of income, including rents, royalties, dividends, and interest are excluded from UBTI, except when such income is derived from "debt-financed property." Income from debt-financed property generally is treated as UBTI in proportion to the amount of debt financing (sec. 514(a)).

An exception to the rule treating income from debt-financed property as UBTI is available to pension trusts, educational institutions, and certain other exempt organizations (collectively referred to as "qualified organizations") that make debt-financed investments in real property (sec. 514(c)(9)(A)). Under this exception, income from investments in real property is not treated as income from debt-financed property. Mortgages are not considered real property for purposes of the exception.

The real property exception to the debt-financed property rules is available for investments in debt-financed property, only if the following six restrictions are satisfied: (1) the purchase price of the real property is a fixed amount determined as of the date of the acquisition (the "fixed price restriction"); (2) the amount of the indebtedness or any amount payable with respect to the indebtedness, or the time for making any payment of any such amount, is not dependent (in whole or in part) upon revenues, income, or profits derived from the property (the "participating loan restriction"); (3) the property is not leased by the qualified organization to the seller or to a person related to the seller (the "leaseback restriction"); (4) in the case of a pension trust, the seller or lessee of the property is not a disqualified person (the "disqualified person restriction"); (5) the seller or a person related to the seller (or a person related to the plan with respect to which a pension trust was formed) is not providing financing in connection with the acquisition of the property (the "seller-financing restriction"); and (6) if the investment in the property is held through a partnership, certain additional requirements are satisfied by the partnership (the "partnership restrictions") (sec. 514(c)(9)(B)(i) through (vi)).

Administration's Proposal

Relaxation of the leaseback and disqualified person restrictions

The proposal relaxes the leaseback and disqualified person restrictions to permit a limited leaseback of debt-financed real property to the seller (or a person related to the seller) or to a disqualified person.[1] The exception applies only where (1) no more than 25 percent of the leasable floor space in a building (or complex of buildings) is leased back to the seller (or related party) or to the disqualified person, and (2) the lease is on commercially reasonable terms.

Relaxation of the seller-financing restriction

The proposal relaxes the seller-financing restriction to permit seller financing on terms that are commercially reasonable independent of the sale and other transactions. The proposal grants authority to the Treasury Department to issue regulations for the purpose of determining commercially reasonable financing terms.

The proposal does not modify the present-law fixed price and participating loan restrictions. Thus, for example, income from real property acquired with seller-financing where the timing or amount of payment is based on revenue, income, or profits from the property generally will continue to be treated as income from debt-financed property, unless some other exception applies.

Relaxation of the fixed price and participating loan restriction for property acquired from financial institutions

The proposal relaxes the fixed price and participating loan restrictions for certain sales of real property foreclosed upon by financial institutions.[2] The relaxation of these rules is limited to cases where: (1) a qualified organization acquires the property from a financial institution that acquired the real property by foreclosure (or after an actual or imminent default), or was held by the financial institution at the time that it entered into conservatorship or receivership; (2) any gain recognized by the financial institution with respect to the property is ordinary income; (3) the stated principal amount of the seller financing does not exceed the financial institution's outstanding indebtedness (including accrued but unpaid interest) with respect to the property at the time of foreclosure or

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[1] As under present law, a leaseback to a disqualified person subject to the prohibited transaction rules set forth in section 4975.

[2] For this purpose, financial institutions include financial institutions in conservatorship or receivership, certain affiliates of financial institutions, and government corporations that succeed to the rights and interests of a receiver or conservator.

default; and (4) the present value of the maximum amount payable pursuant to any participation feature cannot exceed 30 percent of the total purchase price of the property (including any contingent payment).

Effective Date

The proposal would be effective for acquisitions (and also for leases entered into) on or after January 1, 1994.

b. Repeal of the automatic UBTI rule for publicly-traded partnerships

Present Law

In general, the character of a partner's distributive share of partnership income is the same as if the income had been directly realized by the partner. Thus, whether a tax-exempt organization's share of income from a partnership (other than from a publicly-traded partnership) is treated as unrelated business income depends on the underlying character of the income (sec. 512(c)(1)).

By contrast, a tax-exempt organization's distributive share of gross income from a publicly-traded partnership (that is not otherwise treated as a corporation) automatically is treated as gross income derived from an unrelated trade or business (sec. 512(c)(2)(A)). The organization's share of the partnership deductions is allowed in computing the organization's UBTI (sec. 512(c)(2)(B)).

Administration's Proposal

The proposal would repeal the rule that automatically treats income from publicly-traded partnerships as UBTI. Thus, under the provision, investments in publicly-traded partnerships are treated the same as investments in other partnerships for purposes of the UBTI rules.

Effective Date

The proposal would be effective for partnership years beginning on or after January 1, 1994.

c. Permit title-holding companies to receive small amounts of UBTI

Present Law

Section 501(c)(2) provides tax-exempt status to certain corporations organized for the exclusive purpose of holding title to property and remitting over any income from the property to one or more related tax-exempt organizations. Section 501(c)(25) provides tax-exempt status to certain corporations and trusts

that are organized for the exclusive purposes of acquiring and holding title to real property, collecting income from such property, and remitting the income to no more than 35 shareholders or beneficiaries that are: (1) qualified pension, profit-sharing, or stock bonus plans (sec. 401(a)); (2) governmental pension plans (sec. 414(d)); (3) the United States, a State or political subdivision, or governmental agencies or instrumentalities; or (4) tax-exempt charitable, educational, religious, or other organizations described in section 501(c)(3). However, the IRS has taken the position that a title-holding company described in section 501(c)(2) or 501(c)(25) will lose its tax-exempt status if it generates any amount of certain types of UBTI.[3]

Administration's Proposal

The proposal would permit a title-holding company that is exempt from tax under sections 501(c)(2) or 501(c)(25) to receive UBTI (that would otherwise disqualify the company) up to 10 percent of its gross income for the taxable year, provided that the UBTI is incidentally derived from the holding of real property. For example, income generated from parking or operating vending machines located on real property owned by a title-holding company generally would qualify for the 10-percent de minimis rule, while income derived from an activity that is not incidental to the holding of real property (e.g., manufacturing) would not qualify. In cases where unrelated income is incidentally derived from the holding of real property, receipt by a title-holding company of such income (up to the 10-percent limit) will not jeopardize the title-holding company's tax-exempt status, but nonetheless, will be subject to tax as UBTI.

In addition, the proposal provides that a section 501(c)(2) or 501(c)(25) title-holding company will not lose its tax-exempt status if UBTI that is incidentally derived from the holding of real property exceeds the 10-percent limitation, provided that the title-holding company establishes to the satisfaction of the Secretary of the Treasury that the receipt of UBTI in excess of the 10-percent limitation was inadvertent and reasonable steps are being taken to correct the circumstances giving rise to such excess UBTI.

Effective Date

The provision would be effective for taxable years beginning on or after January 1, 1994.

d. Exclusion from UBTI of gains from the disposition of

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[3] IRS Notice 88-121, 1988-2 C.B. 457. See also Treas. Reg. sec. 1.501(c)(2)-1(a).

real property acquired from financial institutions in conservatorship or receivership

Present Law

In general, gains or losses from the sale, exchange or other disposition of property are excluded from UBTI (sec. 512(b)(5)). However, gains or losses from the sale, exchange or other disposition of property held primarily for sale to customers in the ordinary course of a trade or business are not excluded from UBTI (the "dealer UBTI rule") (sec. 512(b)(5)(B)).

Administration's Proposal

The proposal would provide an exception to the dealer UBTI rule by excluding gains and losses from the sale, exchange or other disposition of certain real property and mortgages acquired from financial institutions that are in conservatorship or receivership. Only real property and mortgages owned by a financial institution (or that was security for a loan held by the financial institution) at the time that the institution entered conservatorship or receivership are eligible for the exception.

The exclusion is limited to properties designated as disposal property within nine months of acquisition, and disposed of within two-and-a-half years of acquisition. The two-and-a-half year disposition period may be extended by the Secretary if an extension is necessary for the orderly liquidation of the property. No more than one-half by value of properties acquired in a single transaction may be designated as disposal property.

The exclusion is not available for properties that are improved or developed to the extent that the aggregate expenditures on development do not exceed 20 percent of the net selling price of the property.

Effective Date

The proposal would be effective for property acquired on or after January 1, 1994.

e. Exclusion of certain option premiums and loan commitment fees from UBTI

Present Law

Income from a trade or business that is unrelated to an exempt organization's purpose generally is UBTI. Passive income such as dividends, interest, royalties, and gains or losses from the sale, exchange or other disposition of property generally is excluded from UBTI (sec. 512(b)). In addition, gains on the lapse or termination of options on securities are explicitly

exempted from UBTI (sec. 512(b)(5)).

Present law is unclear on whether premiums from unexercised options on real estate and loan commitment fees are UBTI.

Administration's Proposal

The proposal would expand the current exception for gains on the lapse or termination of options on securities to gains or losses from such options (without regard to whether they are written by the organization), from options on real property, and from the forfeiture of good-faith deposits (that are consistent with established business practice) for the purchase, sale or lease of real property.

In addition, the proposal would provide that loan commitment fees are excluded from UBTI. For purposes of this proposal, loan commitment fees are non-refundable charges made by a lender to reserve a sum of money with fixed terms for a specified period of time. These charges are to compensate the lender for the risk inherent in committing to make the loan (e.g., for the lender's exposure to interest rate changes and for potential lost opportunities).

Effective Date

The proposal would be effective for premiums or loan commitment fees that are received on or after January 1, 1994.

5. Increase recovery period for depreciation of nonresidential real property

Present Law

A taxpayer is allowed to recover, through annual depreciation allowances, the cost or other basis of nonresidential real property (other than land) that is used in a trade or business or that is held for the production of rental income. For regular tax purposes, the amount of the depreciation deduction allowed with respect to nonresidential real property for any taxable year generally is determined by using the straight-line method and a recovery period of 31.5 years. For alternative minimum tax purposes, the amount of the depreciation deduction allowed with respect to nonresidential real property for any taxable year is determined by using the straight-line method and a recovery period of 40 years.

Administration's Proposal

For regular tax purposes, nonresidential real property would be depreciated using the straight-line method and a recovery period of 37 years.

Effective Date

The proposal generally would apply to property placed in service on or after February 25, 1993. The proposal would not apply to property that a taxpayer places in service before January 1, 1994, if (1) the taxpayer or a qualified person entered into a binding written contract to purchase or construct the property before February 25, 1993, or (2) construction of the property was commenced by or for the taxpayer or a qualified person before February 25, 1993. A qualified person for this purpose is any person who transfers rights in such a contract or such property to the taxpayer without first placing the property in service.

E. Other Provisions

1. Permanent extension of AMT treatment of gifts of appreciated property

Present Law

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the fair-market value of property contributed to a charitable organization.[1] However, in the case of a charitable contribution of inventory or other ordinary-income property, short-term capital gain property, or certain gifts to private foundations, the amount of the deduction is limited to the taxpayer's basis in the property.[2] In the case of a charitable contribution of tangible personal property, a taxpayer's deduction is limited to the adjusted basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose (sec. 170(e)(1)(B)(i)).

For purposes of computing alternative minimum taxable income (AMTI), the deduction for charitable contributions of capital gain property (real, personal, or intangible) is disallowed to the extent that the fair-market value of the property exceeds its adjusted basis (sec. 57(a)(6)). However, in the case of a contribution made in a taxable year beginning in 1991 or made before July 1, 1992, in a taxable year beginning in 1992, this rule does not apply to contributions of tangible personal property.

For taxable years beginning after 1989, the AMTI of a corporation is increased by 75 percent of the amount by which adjusted current earnings (ACE) exceeds AMTI (calculated before this adjustment). ACE generally is computed pursuant to the rules that a corporation uses to determine its earnings and profits (sec. 56(g)).

Administration's Proposal

The proposal would eliminate the treatment of

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[1] The amount of the deduction allowable for a taxable year with respect to a charitable contribution may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer (secs. 170(b) and 170(e)).

[2] Section 170(e)(3) provides an augmented deduction for certain corporate contributions of inventory property for the care of the ill, the needy, or infants.

contributions of appreciated property as a tax preference for AMT purposes. Thus, the deduction allowable for a contribution of appreciated property generally would be the same for both regular tax and AMT purposes, and generally would equal the full fair market value of the contributed property. Similar rules would be provided for the ACE component of the corporate AMT.

Effective Date

The proposal would apply to contributions of tangible personal property made after June 30, 1992, and contributions of other property made after December 31, 1992.

2. Permanent extension of General Fund transfer to Railroad Retirement Tier 2 Fund

Present Law

A portion of the Railroad Retirement Tier 2 benefits are included in gross income of recipients (similar to the treatment accorded recipients of private pensions) for Federal income tax purposes. The proceeds from the income taxation of Railroad Retirement Tier 2 benefits received prior to October 1, 1992, have been transferred from the General Fund of the Treasury to the Railroad Retirement Account. Proceeds from the income taxation of benefits received after September 30, 1992 remain in the General Fund.

Administration's Proposal

The transfer of proceeds from the income taxation of Railroad Retirement Tier 2 benefits from the General Fund of the Treasury to the Railroad Retirement Account would be made permanent.

Effective Date

The proposal would be effective for taxes on benefits received after September 30, 1992.

3. Temporary extension of health insurance deduction for self-employed individuals

Present Law

Under present law, an incorporated business can generally deduct, as an employee compensation expense, the full cost of any health insurance coverage provided for its employees (including owners serving as employees) and its employees' spouses and dependents. By contrast, a self-employed individual operating through an unincorporated business can only deduct the cost of health insurance coverage for the individual and his or her dependents to the extent that it, together with their other allowable medical expenses, exceeds 7.5 percent of adjusted gross income. Self-employed individuals can deduct the cost of health insurance for employees as employee compensation. Other persons who purchase heath insurance can deduct the cost of the insurance only to the extent that it, together with their other medical expenses, exceed 7.5 percent of adjusted gross income.

For coverage prior to July 1, 1992, a self-employed individual was allowed to deduct as a business expense up to 25 percent of the amount paid for health insurance coverage for the taxpayer, the taxpayer's spouse, and the taxpayer's dependents. Only amounts paid prior to July 1, 1992 are eligible for deduction. The deduction was not allowed if the self-employed individual or his or her spouse was eligible for employer-paid health benefits.

Administration's Proposal

The proposal would extend the 25-percent deduction through December 31, 1993, and provide that the determination of whether the self-employed individual and his or her spouse are eligible for employer-paid health benefits is made on a monthly basis.

Effective Date

The proposal would be effective for taxable years ending after June 30, 1992.

F. Customs Officer Overtime Pay Reform

Present Law

Customs inspectors' compensation for overtime work is authorized by 19 U.S.C. 267, and paid at rates different from most other Federal employees.

Customs inspectors are compensated with overtime pay for work performed outside the statutorily-defined work week (i.e., Monday through Saturday, 8:00 a.m. through 5:00 p.m). Overtime pay is paid at a rate of two times basic pay, with any amount of work conducted during a two-hour period treated as four hours pay (two hour minimum at a rate of two times basic pay). Customs inspectors who are required to work after their normal duty (callback), between 5:00 p.m. and 9:00 p.m., are paid overtime beginning 5:00 p.m. and for hours actually worked, at a rate of two times basic pay. Customs inspectors who are required to work after their normal duty (callback), between 9:00 p.m. and 6:00 a.m., are paid for eight hours (four minimum hours at a rate of two times basic pay), plus hours actually worked of at least four hours (two minimum hours at a rate of two times basic pay), for a total of 12 hours pay for any time worked. Customs inspectors are compensated with overtime pay for work performed at night and on Sundays and holidays, plus certain minimum hour credits, at a rate of two times basic pay. At night (after 5:00 p.m. and before 8:00 a.m.), Customs inspectors are compensated with four hours pay (two hours minimum at a rate of two times basic pay) for any time worked. On Sundays, Customs inspectors are compensated with 16 hours pay (eight hours minimum at a rate of two times basic pay) for any time worked. On holidays, Customs inspectors are compensated with 16 hours pay (as on a Sunday) plus basic pay for any time worked.

Customs inspectors may receive up to $25,000 in overtime pay, annually.

Inspectional overtime is reimbursed from the Consolidated Omnibus Reconciliation Act (COBRA) user fee account under a mandatory, permanent, and indefinite appropriation. The COBRA account is not subject to apportionment.

Administration's Proposal

The Administration's proposal would eliminate incentives for wasteful overtime scheduling practices and other opportunities for abuse under present law and would apply the savings from overtime reform to deficit reduction.

Effective Date

Not specified.

G. Empowerment Zones and Enterprise Communities

Present Law

The Internal Revenue Code does not contain general rules that target specific geographic areas for special Federal income tax treatment. Within certain Code sections, however, there are definitions of targeted areas for limited purposes (e.g., low-income housing credit and qualified mortgage bond provisions target certain economically distressed areas). In addition, present law provides favorable Federal income tax treatment for certain U.S. corporations that operate in Puerto Rico, the U.S. Virgin Islands, or a possession of the United States to encourage the conduct of trades or businesses within these areas.

Administration's Proposal

Designation of eligible areas

In general

A total of 10 empowerment zones and 100 enterprise communities would be designated (subject to availability of eligible areas) during 1994 and 1995. Empowerment zones and enterprise communities would be designated from areas nominated by State and local governments or a governing body of an Indian reservation. Empowerment zones would be eligible for additional tax incentives beyond those provided in the 100 areas which would be designated as enterprise communities.

The Secretary of Housing and Urban Development (HUD) would designate in eligible urban areas six empowerment zones and 65 enterprise communities. (The six empowerment zones located in urban areas would include at least one zone in an urban area the most populous city of which has a population of 500,000 or less.) The Secretary of Agriculture would designate in eligible rural areas[1] three empowerment zones and 30 enterprise communities. In addition, the Secretary of the Interior would designate in eligible Indian reservation areas one empowerment zone and five enterprise communities. Nominated areas located in Indian reservations also would be eligible for designation (provided the bill's criteria are met) as rural areas. All designations would be made in consultation with an Enterprise Board (to be established in the future), which would be composed of officials from various Federal agencies. The designations would be made prior to January 1, 1996.

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[1] For purposes of the proposal, a "rural area" would be any area which is (1) outside a metropolitan statistical area as defined by the Secretary of Commerce, or (2) determined by the Secretary of Agriculture to be a rural area. For purposes of the proposal, the term "urban area" means an area which is not a rural area.

Designations of areas as empowerment zones or enterprise communities generally would remain in effect for 10 years. An area's designation could be revoked if the local government(s) or State(s) modifies the boundaries of the designated area or does not comply with its agreed-upon strategic plan for the area (described below).[2]

Eligibility criteria for zones

The eligibility criteria for urban areas, rural areas, and Indian reservations generally would be the same (except as noted below). To be eligible for designation, a nominated area would be required to possess all of the following characteristics:

Resident population.--An eligible urban area would be subject to a maximum population of the lesser of (1) 200,000, or (2) the greater of 50,000 or 10 percent of the population of the most populous city within the nominated area.[3] Rural areas would be subject to a maximum population of 30,000. Indian reservations would not be subject to a population limit.

General condition.--An eligible area must have a condition of pervasive poverty, unemployment, and general economic distress.

Area.--The nominated area must either (1) have a continuous boundary, or (2) except in the case of a rural area located in more than one State, consist of not more than three noncontiguous parcels. Urban areas must be located entirely within no more than two contiguous States, and rural areas must be located entirely within no more than three contiguous States.

Size.--The nominated area must not exceed 20 square miles for urban areas (1,000 square miles for rural areas and Indian reservations).

Poverty.--Each of the census tracts within a nominated area must have a poverty rate of at least 20 percent;[4] at least 90

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[2] An area's designation could be revoked only after a hearing on the record at which officials of the State and local governments are given an opportunity to participate.

[3] In addition, the Secretary of HUD would be required to designate empowerment zones located in urban areas in such a manner that the aggregate population of such zones does not exceed 750,000.

[4] If areas are not tracted as population census tracts, the equivalent county divisions as defined by the Bureau of the Census for purposes of defining poverty areas would be treated as population census tracts.

percent of the area's census tracts must each have a poverty rate of at least 25 percent; and at least 50 percent of the area's census tracts must each have a poverty rate of at least 35 percent.[5] For purposes of these measurements, unpopulated census tracts and census tracts with limited populations and 75 percent or more zoned for commercial or industrial use will be treated as satisfying the bill's 20-percent and 25-percent poverty rate criteria. Each census tract located in a central business district must have a poverty rate of at least 35 percent.[6] If the nominated area consists of noncontiguous parcels, each parcel must separately satisfy the above poverty criteria.

Strategic plan.--A strategic plan must be submitted by the nominating body for purposes of accomplishing the goals of this legislation.

Contents of strategic plan

In order for a nominated area to be eligible for designation, the local government(s) and State(s) in which the area is located would be required to provide a strategic plan that: (1) describes the coordinated economic, human, community, and physical development plan and related activities proposed for the nominated area; (2) describes the process by which the affected community is a full partner in the process of developing and implementing the plan and the extent to which local institutions and organizations have contributed to the planning process; (3) identifies the amount of State, local, and private resources that will be available in the nominated area and the private/public partnerships to be used, which may include participation by, and cooperation with, universities, medical centers, and other private and public entities; (4) identifies the funding requested under any Federal program in support of the proposed economic, human, community, and physical development and related activities; (5) identifies baselines, methods, and benchmarks for measuring the success of carrying out the strategic plan, including the extent to which poor persons and families will be empowered to become economically self-sufficient, and (6) generally does not include any action to assist any establishment in relocating from an area outside the nominated area to the nominated area.

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[5] The appropriate Secretary may modify one of these poverty criteria by five percentage points for not more than 10 percent of the population census tracts (up to a maximum of five population census tracts) in the nominated area.

[6] The appropriate Secretary has no discretion to reduce the 35-percent poverty rate threshold for tracts located in a central business district.

Selection process and criteria

All designated areas would be selected in accordance with factors to be developed by the Enterprise Board. Generally, the selections of empowerment zones and enterprise communities are to be based on the effectiveness of the strategic plans submitted and the written assurances that such plans will be implemented.

Tax incentives for empowerment zones

Employer wage credit

A 25-percent credit against income tax liability would be available to all employers for the first $20,000 of qualified wages paid to each employee who (1) is a zone resident (i.e., his or her principal place of abode is within the zone), and (2) performs substantially all employment services within the zone in a trade or business of the employer.

The maximum credit per qualified employee would be $5,000 per year. Wages paid to a qualified employee would continue to be eligible for the credit if the employee earns more than $20,000, although only the first $20,000 of wages would be eligible for the credit.[7] The wage credit would be available with respect to a qualified employee, regardless of the number of other employees who work for the employer or whether the employer meets the definition of an "enterprise zone business" (which applies for the investment tax incentives described below).[8]

The credit would be phased out beginning in 2001. The credit rate would be reduced to 20 percent in 2001, 15 percent in 2002, 10 percent in 2003, and 5 percent in 2004. The credit would not be available after December 31, 2004.

Qualified wages would include the first $20,000 of "wages," defined to include (1) salary and wages as generally defined for FUTA purposes, and (2) certain training and educational expenses paid on behalf of a qualified employee, provided that (a) the expenses are paid to an unrelated third party and are excludable from gross income of the employee under section 127 (which is retroactively and permanently extended under another provision of the Administration's proposal), or (b) in the case of an employee

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[7] To prevent avoidance of the $20,000 limit, all employers of a controlled group of corporations (or partnerships or proprietorships under common control) would be treated as a single employer.

[8] Employers would be required to take reasonable steps to notify all qualified zone employees of the availability to eligible individuals of receiving advance payments of the earned income tax credit (EITC).

under age 19, the expenses are incurred by the employer in operating a youth training program in conjunction with local education officials.

The credit would be allowed with respect to full-time and part-time employees. However, the employee must be employed by the employer for a minimum period of at least 90 days. Wages would not be eligible for the credit if paid to certain relatives of the employer or, if the employer is a corporation or partnership, certain relatives of a person who owns more than 50 percent of the business. In addition, wages would not be eligible for the credit if paid to a person who owns more than five percent of the stock (or capital or profits interests) of the employer.[9]

An employer's deduction otherwise allowed for wages paid would be reduced by the amount of credit claimed for that taxable year.

The credit would be allowable to offset up to 25 percent of alternative minimum tax liability.

Expansion of targeted jobs tax credit (TJTC)

The present-law targeted jobs tax credit (sec. 51) would be expanded so that a person who resides in an empowerment zone automatically would be treated as a member of a targeted group for purposes of that credit.[10] Thus, employers (including those located outside of empowerment zones) would be entitled to claim the 40-percent TJTC credit on up to $6,000 of qualified first-year wages paid to employees who reside within an

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[9] The wage credit would not be not available with respect to any individual employed at any facility described in present-law section 144(c)(6)(B) (i.e., a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises). In addition, the wage credit would not be available with respect to any individual employed by a trade or business the principal activity of which is farming (within the meaning of subparagraphs (A) and (B) of section 2032A(e)(5)), but only if, as of the close of the preceding taxable year, the sum of the aggregate unadjusted bases of assets of the farm exceed $500,000.

[10] The TJTC expired on June 30, 1992, but would be permanently extended by another provision contained in the Administration's proposal.

empowerment zone.[11]

As under present-law, an employer's deduction otherwise allowed for wages paid would be reduced by the amount of TJTC claimed for that taxable year.

Definition of "enterprise zone business"

The investment tax incentives for empowerment zones described below (but not the labor incentives described above) would be available only with respect to trade or business activities that satisfy the criteria for an "enterprise zone business." Under the proposal, an "enterprise zone business" would be defined as a corporation or partnership (or proprietorship) if for the taxable year: (1) the sole trade or business of the corporation or partnership is the active conduct of a qualified business within an empowerment zone;[12] (2) at least 80 percent of the total gross income is derived from the active conduct of a "qualified business" within a zone; (3) substantially all of the use of its tangible property occurs within a zone; (4) substantially all of its intangible property is used in, and exclusively related to, the active conduct of such business; (5) substantially all of the services performed by employees are performed within a zone; (6) at least 35 percent of the employees are residents of the zone; and (7) no more than five percent of the average of the aggregate unadjusted bases of the property owned by the business is attributable to (a) certain financial property, or (b) collectibles not held primarily for sale to customers in the ordinary course of an active trade or business.

A "qualified business" would be defined as any trade or business other than a trade or business that consists predominantly of the development or holding of intangibles for sale or license. In addition, the leasing of real property that is located within the empowerment zone to others would be treated as a qualified business only if (1) the leased property is not residential property, and (2) at least 50 percent of the gross rental income from the real property is from enterprise zone businesses. The rental of tangible personal property to others would not be a qualified business unless substantially all of the rental of such property is by enterprise zone businesses or by residents of an empowerment zone.

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[11] Employers located within an empowerment zone would not be allowed to claim the TJTC with respect to an employee if any of such employee's wages were taken into account in determining the employer's empowerment zone wage credit.

[12] This requirement would not apply to a business carried on by an individual as a proprietorship.

Activities of legally separate (even if related) parties would not be aggregated for purposes of determining whether an entity qualifies as an enterprise zone business.

Increased section 179 expensing

The present-law $10,000 expensing allowance for certain depreciable business property provided under section 179 would be increased to $75,000 for qualified zone property of an enterprise zone businesses (as defined above). The types of property eligible for section 179 expensing would be expanded to include buildings used in enterprise zone businesses.

"Qualified zone property" would be defined as depreciable tangible property (including buildings), provided that: (1) such property was acquired by the taxpayer (but not from a related party) after the zone designation took effect; (2) the original use of the property in the zone commences with the taxpayer; and (3) substantially all of the use of the property is in the zone in the active conduct of a trade or business by the taxpayer in the zone. In the case of property which is substantially renovated by the taxpayer, however, such property need not be acquired by the taxpayer after zone designation nor originally used by the taxpayer within the zone if during any 24-month period after zone designation the additions to the taxpayer's basis in such property exceed 100 percent of the taxpayer's basis in such property at the beginning of the period or $5,000 (whichever is greater).

As under present law, the section 179 expensing allowance would be phased out for certain taxpayers with investment in depreciable business property during the taxable year above a specified threshold. However, the present-law phaseout range (i.e., $200,000 to $210,000 of investment during the taxable year) would be increased for enterprise zone businesses to a phaseout range of $200,000 to $350,000 of investment made by the taxpayer during the taxable year.

As under present-law section 179, all component members of a controlled group are treated as one taxpayer for purposes of the expensing allowance and application of the phaseout range (sec. 179(d)(6)). The $75,000 expensing allowance is to apply at both the partnership (and S corporation) and partner (and shareholder) levels.

The increased expensing allowance would apply for purposes of the alternative minimum tax (i.e., it would not be treated as an adjustment for purposes of the alternative minimum tax). The section 179 expensing deduction would be recaptured if the property is not used predominantly in a enterprise zone business (under rules similar to present-law section 179(d)(10)).

Accelerated depreciation

An enterprise zone business (as defined above) would determine depreciation deductions with respect to "qualified zone property" (also defined above) by using the following recovery periods:

3-year property	2 years
5-year property	3 years
7-year property	4 years
10-year property	6 years
15-year property	9 years
20-year property	12 years
Nonresidential real property	22 years

The shorter recovery periods allowed for qualified zone property of enterprise zone businesses would be allowed for alternative minimum tax purposes.

The shorter recovery periods would not be allowed for any property for which either the small business or incremental investment tax credits are determined. If a lease of property is of a type that would allow the lessee to claim either credit, the shorter recovery periods would not apply for the lessor.

Tax-exempt financing

A new category of tax-exempt facility bonds ("enterprise zone facility bonds") would be created to finance qualified zone facilities the principal user of which is an enterprise zone business. Only 25 percent of the amount of qualified enterprise zone facility bonds would count against the State private activity volume cap, provided that enterprise zone residents possess more than a 50-percent ownership interest in the principal user of the bond-proceeds. If the resident ownership requirement is not satisfied, then 50 percent of the qualified enterprise zone facility bonds (rather than 25 percent) would count against the State private activity volume cap.

Qualified enterprise zone facilities would include qualified zone property (as defined above) including: (1) new and used property, and (2) land which is functionally related and subordinate to such property but would not include housing (rental or owner-occupied). Rules similar to those in Section 144(a)(8)(B) would apply to the types of facilities that could be financed with enterprise zone facility bonds. An enterprise zone business would be eligible for up to an aggregate of $3 million in enterprise zone facility bond financing per zone (a maximum of $20 million per business for all zones). Unless otherwise noted, all other tax-exempt bond rules would apply to bonds for enterprise zone facilities.

Generally, where the business receiving enterprise zone facility bond financing ceases to be an enterprise zone business

or otherwise falls into noncompliance, the business is required to make good faith efforts to return to compliance within a reasonable period of time after the noncompliance is discovered. Failure to return to compliance will result in a loss of the interest deduction on such financing.

For purposes of the so-called bank deductibility rules for interest costs of carrying tax-exempt bonds (sec. 265), enterprise zone facility bonds would be treated comparably to bonds issued by a "qualified small issuer."

Tax incentives available in both empowerment zones and enterprise communities

Tax-exempt financing

The tax-exempt financing benefits described above would be available (with one modification) to otherwise qualifying businesses that are located in enterprise communities. The one modification to the tax-exempt financing benefits is that 50 percent (rather than 25 percent) of the amount of the enterprise zone facility bonds would count against the State private activity volume cap.

Resident empowerment savings credit

A tax credit would be available to employers for certain contributions made to a tax-qualified defined contribution plan on behalf of qualified zone employees. The credit would be equal to 50 percent of contributions up to two percent of compensation (as defined in section 414(s)) not in excess of $35,000. If an area is not designated as a tax enterprise zone for an entire taxable year, the $35,000 compensation limit would be ratably reduced to reflect the portion of the year the designation is not in effect.

The credit would be available for contributions to any tax-qualified defined contribution plan other than an employee stock ownership plan, stock bonus plan, or a plan subject to the minimum funding requirements. Contributions could also be made to a simplified employee pension. Except as specifically provided, the rules applicable to qualified plans and SEPs, as the case may be, would apply to contributions for which the credit is available.

To be eligible for the credit, the employer contribution must be 100 percent vested, and must be either a matching or nonelective contribution; salary reduction contributions would not be eligible for the credit. The plan would be required to permit a qualified zone employee to withdraw contributions from the plan (and earnings thereon) for higher education or health expenses, first-time home purchase, or to invest in a qualified enterprise zone business. The 10-percent early withdrawal tax would not apply to such withdrawals.

The credit would be in lieu of the otherwise available deduction for the contributions and would be in addition to the employment and training credit. The credit would be elective.

Low-income housing credit (LIHC) expansion

For purposes of the low-income housing credit (sec. 42)[13], a building located (1) in an empowerment zone or an enterprise community, and (2) in a census tract having a poverty rate of at least 30 percent would be treated as being located in a "difficult to develop" area, within which the eligible basis of buildings for purposes of computing the credit is 130 percent of the cost basis. (Thus, the credit would be based on 91 percent of present value instead of the regular LIHC rate of 70 percent of present value.) The present-law State credit cap and other rules would continue to apply.

Effective Date

Empowerment zone and enterprise community designations would be made only during calendar years 1994 and 1995. The tax incentives would be available during the period that the designation remains in effect, which generally would be a period of 10 years.

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[13] The low-income housing credit expired on June 30, 1992, but would be permanently extended by another provision contained in the Administration's proposal.