[JOINT COMMITTEE PRINT]

SUMMARY OF THE PRESIDENT'S REVENUE PROPOSALS

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a summary of the revenue provisions included in the President's budget proposal, as submitted to the Congress on February 17, 1993.

The provisions summarized in this pamphlet are those revenue proposals contained in the Department of the Treasury document, *Summary of the Administration's Revenue Proposals*, February 1993 ("Treasury document"). The pamphlet also summarizes three other revenue proposals included in the Office of Management and Budget document, *A Vision of Change for America*, February 17, 1993 ("OMB document"), that would amend the Internal Revenue Code: taxation of social security benefits; increase in inland waterways fuel excise tax; and use of Harbor Maintenance Trust Fund amounts for administrative expenses.[2]

The pamphlet descriptions of the President's proposals are taken without modification from the Treasury document and the OMB document. The pamphlet summary description includes present law and a reference to any recent prior Congressional action on the topic and whether the proposal (or a similar proposal) was included in recent budget proposals (fiscal years 1990-1993). Part I of the pamphlet summarizes the revenue-reduction proposals from the Treasury document; Part II summarizes the revenue-raising proposals from the Treasury document; and Part III summarizes three additional revenue proposals from the OMB document.

The Treasury document's introductory statement indicates that "[t]he descriptions included in this report are not intended to be final. Many of the proposals will be revised in the process of finalizing the Administration's fiscal year 1994 Budget. The descriptions are also not intended to be comprehensive. Numerous details, such as rules relating to the prevention of abusive transactions and the limitation of tax benefits consistent with the principles of the proposals, will be provided in connection with the presentation of the Budget and upon submission of legislation to implementation the Administration's plan."

Further, the Treasury document states that "[i]n addition to the proposals summarized in this report, the Administration also supports initiatives to promote sensible and equitable administration

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Summary of the President's Revenue Proposals* (JCS-4-92), March 8, 1993.

[2] The exclusion from this pamphlet of certain "fee" or other revenue-related proposals included in the OMB document neither is intended to create any inference as to the jurisdiction of the House Committee on Ways and Means or the Senate Committee on Finance with respect to such proposals, nor is intended to create any inference regarding the classification of such fees or other revenue-related provisions under the categories established by the Budget Enforcement Act of 1990.

of the internal revenue laws. These include simplification, good governance and technical correction proposals." [3]

[3] For a description of the Tax Simplification Act of 1993 (H.R. 13), introduced by Ways and Means Committee Chairman Dan Rostenkowski, see Joint Committee on Taxation, *Technical Explanation of the Tax Simplification Act of 1993 (H.R. 13)* (JCS-1-93), January 8, 1993. For a description of the Technical Corrections Act of 1993 (H.R. 17), introduced by Ways and Means Committee Chairman Dan Rostenkowski, see Joint Committee on Taxation, *Explanation of the Technical Correction Act of 1993 (H.R. 17)* (JCS-2-93), January 8, 1993.

I. REVENUE-REDUCTION PROVISIONS

A. Training and Education Provisions

1. Permanent extension of employer-provided education 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 education assistance provided to the employee if such amounts were paid or incurred pursuant to an educational assistance program that met certain requirements. 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 the purpose 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.

President's Proposal

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

Effective Date

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

Prior Action

A similar provision was included in H.R. 11 and H.R. 4210, as passed by the Congress in 1992 and vetoed by President Bush.

2. Permanent extension of targeted jobs tax credit and expansion to include youth apprenticeship 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.

President's Proposal

The proposal would permanently extend the targeted jobs tax credit. The provision is effective for individuals who begin work for the employer after June 30, 1992. In addition, the targeted jobs tax credit would be expanded to include youth apprentices beginning work after December 31, 1993.

A youth apprentice would be any individual aged 16 through 20 who was enrolled in a qualified youth apprenticeship program beginning in the eleventh or twelfth grade and certified by the local education agency or other authorized institution participating in the program to be making satisfactory progress in completing the program. A program would be considered to be a qualified youth apprenticeship program only if it is a planned program of structured job training designed to integrate academic instruction and work-based learning, is administered by a committee composed of the Secretaries of Labor and Education (in addition to other par-

ticipants), and is established on or after the date of enactment of the expanded credit.

Because the youth apprenticeship 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. In addition, the targeted jobs tax credit would be expanded to include youth apprentices beginning work after December 31, 1993.

Prior Action

H.R. 4210, as passed by Congress in 1992, provided for a one-year extension of the targeted jobs tax credit (from June 30, 1992, to June 30, 1993), but did not include a youth apprenticeship program. H.R. 11, as passed by Congress in 1992, provided for a permanent extension of the targeted jobs tax credit with modifications, but did not include a youth apprenticeship program. Both bills were vetoed by President Bush. In addition, temporary extensions of the targeted jobs tax credit were included in President Bush's budget proposals for fiscal years 1992 and 1993.

B. Capital Investment and Economic Growth

1. Investment tax credit

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. 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.

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.

President's Proposal

Two separate investment tax credit systems would be provided, one for small businesses and one for large businesses. Property eligible for the credits generally would be defined in the same manner as under the regular investment tax credit prior to its repeal, except that used property and certain other categories of property would not be eligible. Certain modifications of the eligibility requirements, such as placed-in-service rules, would be made to simplify administration of the rules and reduce controversies. Leased property would be subject to limitations to prevent shifting of the credit to firms more able to claim the credit. Related party and aggregation rules would be provided for use in determining eligibility and application of the investment tax credit rules described below.

The credits would be part of the section 38 general business credit and, therefore, would be subject to current law limitations

on use of that credit. The portion of the general business credit attributable to the credits could be used by any taxpayer to offset up to 25 percent of the tentative minimum tax. As under current 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.

Small business investment tax credit

The small business investment tax credit would be a permanent credit. The rate would be 7 percent for property placed in service after December 3, 1992 and on or before December 31, 1994, and 5 percent for property placed in service on or after January 1, 1995. For 3-year property, the credit would be one-third of the regular rate; 5-year property would receive a credit of two-thirds of the regular rate; and 7-year property would receive a credit of four-fifths of the regular rate. Property with a recovery period in excess of 7 years would receive a credit at the full regular rate.

A small business would generally 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 small business investment tax credit would generally be similar to the regular investment credit prior to the 1986 Act. Recapture rules would apply to early dispositions of property. The taxpayer's depreciable basis would be reduced by the amount of the credit.

The small business credit would be subject to an annual cap intended to prevent abuses of the $5 million gross receipts rules. Any investment in excess of the cap would not be eligible for the small business investment credit. However, prior to 1995, an eligible small business could elect to use the incremental investment tax credit in lieu of the small business credit with respect to all of its investment in a taxable year.

Incremental investment tax credit

The incremental investment tax credit would be a temporary credit. Taxpayers not qualifying as small businesses would use the incremental credit. Taxpayers would be eligible to claim the credit for the excess of their investment in qualified property over a fixed base. The rate would be 7 percent for property placed in service after December 3, 1992 and on or before December 31, 1994. For a calendar year taxpayer, credits with respect to assets placed in service after December 3, 1992 and on or before December 31, 1992 could be claimed on a taxpayer's return for 1992 or, at the taxpayer's option, for 1993.

The fixed base would equal a percentage of a taxpayer's average historic investment in new and used property in 1989 through 1991, or, if the taxpayer elects, with respect to investments in 1987 through 1991. The amount of historic investment would be indexed for growth in the gross domestic product, and multiplied by 70 percent to determine the fixed base through December 31, 1993, and

multiplied by 80 percent to determine the fixed base for 1994. Taxpayers would not be permitted to claim the credit on more than 50 percent of qualified investment in a taxable year. Thus, a firm with a fixed base of $1 million and qualifying investment of $6 million would only be permitted to claim the credit with respect to $3 million of investment.

Mandatory qualified progress expenditure rules would allow a credit for the appropriate portion of an asset with a lengthy construction period. Under these rules, a credit would be allowed for certain progress expenditures attributable to periods after December 3, 1992 and before January 1, 1995, even though the asset is not placed in service until after December 31, 1994. In addition, certain progress expenditures attributable to periods prior to December 4, 1992 would not be eligible for the credit, even though the asset is placed in service after December 3, 1992 and on or before December 31, 1994.

In determining a taxpayer's qualified investment for a taxable year, there would be taken into account one-third of the basis of 3-year property, two-thirds of the basis of 5-year property, four-fifths of the basis of 7-year property, and all of the basis of property with a recovery period of more than seven years. In lieu of basis reduction, taxpayers would be required to include in income the amount of the credit ratably over the recapture period. Special rules would be provided for applying the incremental investment tax credit to start-up firms.

Recapture rules would be provided to limit any advantage from bunching of investments in 1993 and 1994. These rules would require repayment of all or a portion of the credits if the taxpayer's investment drops below the fixed base. These rules would apply through 1997. For 1995 through 1997, the fixed base, relevant solely for recapture purposes, would be determined by multiplying the historic base by 80 percent.

Effective Date

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

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.[4]

President's Proposal

The proposal would permanently 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

---

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

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.

Prior Action

A one-year extension of the research tax credit was provided for by H.R. 11 and H.R. 4210, as passed by the Congress in 1992 and vetoed by President Bush. In addition, President's Bush's budget proposals for fiscal years 1990, 1991, 1992, and 1993 contained provisions to extend permanently the research tax credit.

3. Capital gains exclusion for certain small business stock

Present Law

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

The Tax Reform Act of 1986 repealed a provision allowing a noncorporate taxpayer a deduction for 60 percent of its net capital gain for the taxable year.

President's Proposal

Investors who hold qualified small business stock for at least 5 years would be permitted to exclude 50 percent of gains realized on the disposition of their stock. A qualified small business is a subchapter C corporation with less than $25 million of aggregate capitalization from January 1, 1993, through the date the taxpayer acquires stock in the corporation, that uses substantially all of its assets in the active conduct of a trade or business during substantially all of the taxpayer's holding period. Certain activities, including personal service, banking, leasing, real estate, farming, mineral extraction, and hospitality businesses, cannot be qualified small businesses. Qualified small business stock must be acquired directly by an individual taxpayer (or indirectly by an individual taxpayer through an investment partnership or other pass-through entity) after December 31, 1992, and at its original issue (either directly from the corporation or through an underwriter). Subchapter C corporations that hold stock in a qualified small business would not qualify for the exclusion.

Individuals would be allowed to exclude 50 percent of capital gains realized upon the disposition of qualified small business stock held over 5 years, and would apply their current statutory rate on capital gains (either 15 or 28 percent) to the reduced amount of taxable gain. Gain eligible for the exclusion would be limited to the greater of ten times the investor's basis in the stock or $1 million for each qualified small business. One half of any exclusion claimed would be treated as a tax preference item under the individual alternative minimum tax.

The proposal includes safeguards to prevent large corporations from securing the exclusion for their shareholders by spinning off new subsidiaries, to prevent existing small corporations from redeeming outstanding shares in hopes of reissuing qualified small business stock, and to prevent investors from securing the exclusion for certain transfers, including the transfer of unrealized gains on appreciated assets to a qualified small business.

Effective Date

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

Prior Action

Similar provisions were included in H.R. 4210, as passed by the Congress in 1992 and vetoed by President Bush, and in H.R. 11 as passed by the Senate (and deleted in Conference).

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 depreciation method for regular tax purposes. If a tax-

payer uses the straight-line method for regular tax purposes, it must also use the straight-line method for AMT purposes.

President's Proposal

Under the proposal, the depreciation component of the adjustment used in computing ACE would be eliminated, and the AMT depreciation would be computed using the 120 percent declining-balance depreciation method over the recovery periods applicable for regular tax purposes. The amendment would not apply to property eligible only for the straight-line method for regular tax purposes (e.g., residential and nonresidential real property).

Effective Date

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

Prior Action

H.R. 4210 and H.R. 11, as passed by the Congress in 1992 and vetoed by President Bush, contained provisions that would have changed depreciation for AMT purposes. President Bush's fiscal year 1993 budget proposal also contained a provision to change AMT depreciation. These provisions would have eliminated the depreciation component of the ACE adjustment and provided that AMT depreciation would be computed using the 150 percent declining balance method over the class life of the property to which the proposals applied.

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.

President'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.

Prior Action

The Senate amendment to H.R. 776 (The Energy Policy Act of 1992) included this provision, but it was not included in the conference agreement.

6. Permanent extension of qualified small-issue bonds

Present Law

Interest on certain small issues of private activity bonds is exempt from tax 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.

President's Proposal

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

Effective Date

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

Prior Action

H.R. 4210, as passed by Congress in 1992, provided for a one-year extension of qualified small-issue bonds (from June 30, 1992 to June 30, 1993). H.R. 11, as passed by Congress in 1992, extended qualified small-issue bonds for 15 months (from June 30, 1992 until September 30, 1993). Both bills were vetoed by President Bush. A temporary extension of first-time farmer bonds was included in President Bush's budget proposal for fiscal year 1993.

C. Enterprise Zone Tax Incentives

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.

President's Proposal

The Administration proposes to designate 50 Federal enterprise zones which would benefit from targeted employment and investment incentives. The incentives would stimulate government and private sector revitalization of these distressed areas. The enterprise zones would be designated only from areas nominated by State and local governments and would have to meet certain objective criteria. A detailed proposal will be included in the presentation of the Administration's Budget.

Effective Date

The President's proposal does not indicate an effective date for the enterprise zone provisions.

Prior Action

Enterprise zone provisions were included in H.R. 11 and H.R. 4210, as passed by the Congress in 1992 and vetoed by President Bush. In addition, enterprise zone provisions were included in President Bush's budget proposals for fiscal years 1990, 1991, 1992, and 1993.

D. 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 change over time under present law, as shown in the following table.

Year	One qualifying child—		Two or more qualifying children—	
	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.

President's Proposal

The Administration is committed to lifting more working families above the poverty threshold and to providing a greater work incentive to low-income workers. In order to achieve these goals, the Administration proposes to increase the earned income tax credit. A detailed proposal will be included in the presentation of the Administration's Budget.

Effective Date

No effective date has been specified.

Prior Action

H.R. 4210, as passed by the Congress in 1992, would have repealed the supplemental young child credit, and would have allowed taxpayers to include all health insurance expenses as medical expenses, subject to the 7.5 percent of adjusted gross income (AGI) floor on deductible medical expenses regardless of whether these expenses had been used to claim the supplemental health insurance credit. The bill also would have permitted a self-employed taxpayer to claim the allowable deduction for health insurance costs while using the full amount of such costs related to qualifying children to claim the supplemental health insurance credit. It also would have increased the basic EITC credit rates for families with two or more qualifying children. H.R. 4210 was vetoed by President Bush.

H.R. 11, as passed by the Congress in 1992, would have permitted taxpayers to include all health insurance expenses as medical expenses, subject to the 7.5 percent of adjusted gross income (AGI) floor on deductible medical expenses, regardless of whether these expenses had been used to claim the health insurance component of the EITC. H.R. 11 also would have permitted a self-employed taxpayer to claim the allowable deduction for health insurance costs and to use the full amount of these expenses that are related to coverage of qualifying children to claim the health insurance component of the EITC. The bill would have permitted taxpayers with a qualifying child under the age of 1 year to claim both the young child supplemental component of the EITC and the dependent care tax credit for expenses related to care of the qualifying child. H.R. 11 was vetoed by President Bush.

E. 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.

President's Proposal

The proposal permanently extends 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.

Prior Action

H.R. 4210, as passed by Congress in 1992, provided for a one-year extension of QMBs and MCCs (from June 30, 1992 to June 30, 1993), with modifications. H.R. 11, as passed by Congress in 1992, would have permanently extended QMBs and MCCs with modifications. Both bills were vetoed by President Bush. In addition, a temporary extension of QMBs and MCCs was included in President Bush's budget proposal for fiscal year 1993.

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.

President's Proposal

The proposal would make permanent the low-income housing tax credit.

Effective Date

The provision is effective after June 30, 1992.

Prior Action

H.R. 4210 and H.R. 11, as passed by Congress in 1992, would have permanently extended the low-income housing credit with modifications. Both bills were vetoed by President Bush. In addition, temporary extensions of the low-income housing credit were included in President Bush's budget proposals for fiscal years 1991, 1992, and 1993.

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.

President'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. 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.

Prior Action

Provisions modifying the passive loss rules were included in H.R. 4210, as passed by Congress in 1992, and in H.R. 11, as passed by Congress in 1992 (both bills were vetoed by President Bush), and in President Bush's fiscal 1993 budget proposals.

4. 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.

President's Proposal

For regular tax purposes, nonresidential real property would be depreciated using the straight-line method and a recovery period of 36 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.

Prior Action

H.R. 4210, as passed by Congress in 1992, would have required that the depreciation deduction for regular tax purposes (1) for nonresidential real property be determined using a recovery period of 40 years; and (2) for residential real property, other than low-income housing credit property, be determined using a recovery period of 31 years (rather than 27.5 years as under present law). H.R. 11, as passed by Congress in 1992, would have required that the depreciation deduction for regular tax purposes for nonresidential real property be determined using a recovery period of 40 years. Both bills were vetoed by President Bush.

5. Facilitate real estate investments by pension funds and others

a. Relax restrictions on debt-financed real estate investments by pension funds and others

Present Law

Tax-exempt organizations generally are subject to tax on income from a trade or business that is unrelated to the organization's exempt purposes (the Unrelated Business Income Tax or "UBIT"). Certain types of income, including rents, royalties, dividends, and interest are not subject to UBIT, except when such income is derived from "debt-financed property." An exception to the rule subjecting income from debt-financed property to the UBIT 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.

The real property exception to the debt-financed property rules is available for investments in debt-financed property only if the following five 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 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"). Additional requirements apply if the investment vehicle is a partnership.

President's Proposal

Relax sale-leaseback prohibition.—The sale-leaseback prohibition would be modified to permit a leaseback of up to 25 percent of a debt-financed property to the seller (or a party related to the seller), provided the lease is on commercially reasonable terms, independent of the sale and other transactions.

Allow seller financing.—Seller financing would be permitted on terms that are commercially reasonable, independent of the sale and other transactions. The existing fixed price and participating loan restrictions would apply to seller financing.

Relax fixed sales price and participating loan restrictions for real property acquired from financial institutions.—The fixed price and participating loan restrictions would not apply if: (1) a qualified organization acquires the real property from a financial institution (which would include some subsidiaries, and conservators or receivers); (2) the selling financial institution acquired the real property by foreclosure or default, or held the real property at the time it entered conservatorship or receivership; (3) gain recognized by the

seller of the real property is ordinary income; (4) the seller financing does not exceed the amount of the outstanding indebtedness (including accrued interest) on the real property at the time of the foreclosure or default; and (5) the maximum amount that may be paid pursuant to any participation features does not exceed 30 percent of the total purchase price (i.e., the fixed component and the contingent component) for the real property.

Prior Action

Similar provisions were included in H.R. 11 and H.R. 4210, as passed by the Congress in 1992 and vetoed by President Bush. Similar provisions also were included in President Bush's fiscal year 1993 budget proposal.

b. Repeal rule regarding 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 subject to the UBIT generally depends on the underlying character of the income.

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 income from an unrelated trade or business. The organization's share of the partnership deductions is allowed in computing the organization's unrelated business taxable income ("UBTI").

President's Proposal

The rule subjecting income from publicly traded partnerships to UBIT would be repealed. The income would be subject to UBIT only if the activity conducted by the partnership is unrelated to the exempt purpose of the tax-exempt organization or is taxable under the debt-financed income rules.

Prior Action

A similar provision was included in H.R. 11 and H.R. 4210, as passed by the Congress in 1992 and vetoed by President Bush. A similar provision also was included in the fiscal year 1993 budget proposal.

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

Present Law

Tax-exempt status is provided to certain corporations organized to hold title to real property and remit income to certain tax-exempt persons. These corporations may lose their exempt status if they generate any amount of certain types of UBTI.

President's Proposal

The tax-exempt status of a title-holding company would not be jeopardized if ten percent or less of its gross income is UBTI incidentally derived from holding real property. However, the incidental income would be subject to UBIT.

Prior Action

A similar provision was included in H.R. 11 and H.R. 4210, as passed by the Congress in 1992 and vetoed by President Bush.

d. Exclude from UBTI gains and losses from the disposition of 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. 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.

President's Proposal

There would be excluded from UBTI gains from the sale, exchange, or other disposition of certain real property acquired from financial institutions that are in conservatorship or receivership or from the conservator or receiver of such an institution.

Prior Action

A similar provision was included in H.R. 11 and H.R. 4210, as passed by the Congress in 1992 and vetoed by President Bush.

e. Exclude loan commitment fees and certain option premiums from UBIT

Present Law

Income from a trade or business that is unrelated to an organization's exempt 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. In addition, gains on the lapse or termination of options on securities are explicitly exempted from UBIT.

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

President's Proposal

Loan commitment fees and premiums from unexercised options on real estate would be excluded from UBTI.

Prior Action

A similar provision was included in H.R. 11 and H.R. 4210, as passed by the Congress in 1992 and vetoed by President Bush.

f. Effective dates

The proposals generally would be effective January 1, 1994.

F. 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.[5] 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.[6] 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.

President's Proposal

The proposal would eliminate the tax preference for contributions of appreciated property. The deduction allowable for a contribution of appreciated property would be the same for both regular tax and AMT purposes (and also for adjusted current earnings purposes, in the case of a C corporation), and generally would equal the full fair market value of the contributed property.

Effective Date

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

Prior Action

A similar provision was included in H.R. 11, as passed by the Congress in 1992 and vetoed by President Bush. In addition, H.R. 4210, as passed by the Congress in 1992 and vetoed by President Bush, provided that contributions of appreciated property made during the period January 1, 1992, through June 30, 1993, would not be treated as a tax preference item. President Bush's budget

[5] 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)).

[6] 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.

proposal for fiscal year 1993 contained a provision to eliminate the tax preference for contributions of appreciated property.

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). 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.

President's Proposal

The proposal would permanently extend, retroactive to taxes on benefits received after September 30, 1992, General Fund transfers to the Railroad Retirement trust fund.

Effective Date

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

Prior Action

A similar proposal was included in H.R. 11 and H.R. 4210, as passed by the Congress in 1992 and vetoed by President Bush.

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.

President's Proposal

Extend the 25 percent deduction through December 31, 1993.

Effective Date

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

Prior Action

The proposal is similar to provisions contained in H.R. 11 and H.R. 4210, as passed by the Congress in 1992 and vetoed by President Bush. Those provisions would have extended the deduction through June 30, 1993.

II. 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	$5,535.00 plus 28% of the amount over $36,900.
Over $89,150	$20,165.00 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

Under present law, an individual taxpayer is subject to an alternative minimum tax (AMT) to the extent that the taxpayer's tenta-

tive minimum tax exceeds the taxpayer's regular tax liability. An individual 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, 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.

President's Proposal

New marginal tax rates

The proposal would provide a new 36 percent marginal tax rate that would apply 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 $1,501 and $3,500, and the 31 percent rate would apply to income between $3,501 and $5,500. Under this modified tax rate schedule for estates and trusts, the benefits of the rates below the 39.6 percent surtax rate (described below) for 1993 would approximate the benefits of the 15 and 28 percent rates for 1993 under current law.

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

Alternative minimum tax rate and exemption amounts

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

Surtax on high 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. 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. For married taxpayers filing separate returns, the threshold amount for the surtax would be $125,000.

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. The 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 the changes in tax rates.

Prior Action

Similar individual income tax rate provisions were included in H.R. 4210, as passed by the Congress in 1992 and vetoed by President Bush.

2. 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.

President'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.

Prior Action

The Omnibus Budget Reconciliation Act of 1990 (OBRA 1990) de-coupled the wage base for the HI tax and the OASDI tax. OBRA 1990 increased the wage base for the HI tax to $125,000 (indexed for changes in the average wages in the economy).

3. 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.)

President's Proposal

The top estate and gift tax rate 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.

Prior Action

A similar provision was contained in H.R. 11, as passed by the Congress in 1992 and vetoed by President Bush.

4. 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.

President'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.

5. 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.[7]

President's Proposal

Under the proposal, no deduction would be permitted for club dues for taxable years beginning after December 31, 1993. This rule

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

would apply to all types of clubs, 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.

Effective Date

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

Prior Action

A similar provision was included in H.R. 11, as passed by the Congress in 1992 and vetoed by President Bush.

6. Deny deduction for executive pay over one million dollars

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.

President's Proposal

The proposal would preclude a corporation from taking a deduction for compensation paid to an executive in excess of $1 million per year. However, the $1 million limitation would not apply to compensation payments that are linked to productivity. The Treasury is reviewing appropriate standards regarding this exception. Certain other payments also would be excluded from the deduction limit, such as payments made to a tax-qualified retirement plan and certain fringe benefits that are excludable from gross income by the executive.

Effective Date

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

Prior Action

A similar provision was included in H.R. 4210, as passed by the Congress in 1992 and vetoed by President Bush and in the Unemployment Compensation Amendments Act of 1992 as passed by the House (but deleted in conference). Those provisions did not have an exception for compensation payments that are linked to productivity.

7. 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.

President'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

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.

8. 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 en route; 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 de-

ducted for certain qualified expenses for the sale and 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 his former residence, if he has no former place of work).

President'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 near 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

No effective date has been specified.

Prior Action

H.R. 4210, as passed by the Congress in 1992, would have: (1) increased the mileage limitation from 35 to 75 miles; (2) repealed the $1,500 limit on pre-move househunting and temporary living expenses in the general location of the new job (the overall $3,000 was retained); (3) allowed an above-the-line deduction under section 62 in computing adjusted gross income for an amount equal to the otherwise allowable deduction for moving expenses, but only to the extent such expenses are reimbursed and included in the gross income of the taxpayer under section 82; and (4) would have made the deduction subject to the 2-percent floor on miscellaneous itemized deductions to the extent that expenses are unreimbursed. H.R. 4210 was vetoed by President Bush.

H.R. 11, as passed by the Congress in 1992, would have: (1) increased the mileage limitation from 35 to 60 miles; (2) provided for an overall cap of $10,000; (3) denied the deduction for expenses for the sale or purchase of a residence or settlement of a lease; and (4) denied the deduction for the otherwise allowable expenses for meals and entertainment expenses. H.R. 11 was vetoed by President Bush.

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. 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.

President's Proposal

The proposal would provide a new 36 percent marginal tax rate on corporate taxable income in excess of $10 million. 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. Penalties for the underpayment of estimated taxes, however, 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, the committees, or individual members, of Congress or of any legislative body of a State, a possession of the United States, or a political subdivision of any of the foregoing 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.

Section 162(e)(2) provides, however, that no deduction is allowed for any amount paid (whether by contribution, gift, or otherwise) 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").

Treasury Department regulations further provide that if expenditures for lobbying purposes do not meet the requirements of section 162(e)(1), then such expenditures are not deductible as ordinary and necessary business expenses (Treas. Reg. sec. 1.162-20(c)(1)). The regulations provide, however, that expenditures for institutional or "good will" advertising which keeps the taxpayer's name before the public are generally deductible, provided such expenditures are related to the patronage the taxpayer might reasonably expect in the future (Treas. Reg. sec. 1.162-20(a)(2)).[8]

Rules governing lobbying by charities

Although most tax-exempt organizations (e.g., social welfare organizations and trade associations) generally may engage in unlimited lobbying efforts, a charitable organization otherwise described in section 501(c)(3) is not entitled to tax-exempt status under that section if a substantial part of its activities is "carrying on propaganda, or otherwise attempting, to influence legislation." [9] There is no statutory definition under section 501(c)(3) of "propaganda, or otherwise attempting, to influence legislation," but Treasury regulations provide that 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 (meaning action by Congress or another legislative body). Treas. Reg. sec. 1.501(c)(3)-1(c)(3). However, an organization will not fail to meet the requirements of section 501(c)(3) merely because it advocates, as an insubstantial part of its activities, the adoption or rejection of legislation. *Id.* Moreover, 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.[10]

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[8] See also Treasury proposed regulation 1.162-20(c)(4) (proposed November 25, 1980), providing a three-part test to distinguish nondeductible "grass roots" lobbying from deductible institutional advertising.

Prior to 1963, Treasury Department regulations (originally dating back to 1915) provided that *all* expenditures for lobbying purposes, for the promotion or defeat of legislation, for political campaign purposes, or for propaganda (including advertising) related to any such purposes, were not deductible as "ordinary and necessary" business expenses. See *Cammarano v. United States*, 358 U.S. 498 (1959)(upholding validity of regulation denying deduction for lobbying expenses, even if expenses related to proposed legislation that affected the very survival of the taxpayer's business). 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.

[9] See *Regan v. Taxation With Representation*, 461 U.S. 540 (1983)(upholding constitutionality of section 501(c)(3) lobbying restriction).

[10] See Rev. Rul. 70-79, 1970-1 C.B. 127; Rev. Rul. 70-449, 1970-2 C.B. 111; *Slee v. Commr.* 42 F.2d 184 (2d Cir. 1930).

For public charities making the 501(h) election, permitted lobbying expenditures are measured against a specific arithmetical test.[11] Under 501(h), "lobbying expenditures" are defined as "expenditures for the purpose of influencing legislation (as defined in section 4911(d))." Section 4911(d), in turn, defines the term "influencing 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." [12]

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

> "(A) making available the results of nonpartisan analysis, study, or research [13]
>
> (B) providing of technical advice or assistance (where such advice would otherwise constitute the influencing of legislation) to a governmental body or to a committee or

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[11] For organizations making the 501(h) election, the allowable amount of all lobbying expenditures for any tax year is the lesser of: (1) $1 million or (2) the sum of (a) 20 percent of the first $500,000 of the organization's exempt purpose expenditures for the year, plus (b) 15 percent of the next $500,000 of such expenditures, plus (c) 10 percent of the third $500,000 of such expenditures, plus (d) five percent of any additional such expenditures. "Grass roots" lobbying expenditures are limited to 25 percent of the overall permissible lobbying amount (sec. 4911(c)). Certain affiliated organizations are treated as one organization for purposes of applying the 501(h) arithmetical test.

Under section 501(h), if lobbying expenditures (for either all lobbying or grass roots lobbying in particular) made during a taxable year exceed the allowable amounts, an excise tax is imposed on the organization equal to 25 percent of the excess lobbying expenditures (sec. 4911(a)). If the sum of the electing organization's lobbying expenditures during a four-year period exceeds 150 percent of the sum of the allowable amounts during that period, then the organization loses its tax-exempt status under section 501(c)(3) (Treas. Reg. sec. 1.501(h)-3(b)).

[12] For purposes of section 4911, the term "legislation" includes action taken by a legislative body, meaning the "introduction, amendment, enactment, defeat, or repeal of Acts, bills, resolutions, or similar items" but does not include action taken by executive, judicial, or administrative bodies. See Treas. Reg. sec. 56.4911-2(d).

[13] Under the section 4911 regulations, "nonpartisan analysis, study, or research" means an independent and objective exposition of a particular subject matter, including any activity that is "educational" within the meaning of sec. 1.501(c)(3)-1(d)(3). Thus, "nonpartisan analysis, study, or research" may advocate a particular position or viewpoint so long as there is a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent opinion or conclusion. The mere presentation of unsupported opinion, however, does not qualify as "nonpartisan analysis, study, or research." The determination of whether a publication or broadcast qualifies as "nonpartisan analysis, study, or research" generally is made on a presentation-by-presentation basis, but if a publication is prepared as part of a series, the series as a whole will be judged against the standards determining whether it is "nonpartisan analysis, study or research." Nonpartisan analysis may be made available to the general public, a segment thereof, or governmental bodies Communications may not be limited to, or be directed toward, persons who are interested solely in one side or a particular issue. Treas. Reg. sec. 56.4911-2(c)(1).

Similarly, a regulation under section 4911 provides that "[e]xaminations and discussions of broad social, economic, and similar problems are neither direct lobbying communications . . . nor grass roots lobbying communications . . . even if the problems are of the type with which government would be expected to deal ultimately. Thus, . . . lobbying communications do not include public discussion, or communications with members of legislative bodies or governmental employees, the general subject of which is also the subject of legislation before a legislative body, so long as such discussion does not address itself to the merits of a specific legislative proposal and so long as such discussion does not directly encourage recipients to take action with respect to legislation." Treas. Reg. sec. 56.4911-2(c)(2)

other subdivision thereof in response to a written request by such body or subdivision, as the case may be;[14]

(C) appearances before, or communications to, any legislative body with respect to 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) communications between the organization and its bona fide members with respect to legislation or proposed legislation of direct interest to the organization and such members, other than communications . . . [which directly encourage members to contact a legislative body in an attempt to influence legislation, or which directly encourage members to urge persons other than members to attempt to affect the opinions of the general public or to contact a legislative body in an attempt to influence legislation]; and

(E) any communication with a government official or employee, other than—

(i) a communication with a member or employee of a legislative body (where such communication would otherwise constitute the influencing of legislation), or

(ii) a communication the principal purpose of which is to influence legislation."

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. Section 4945(d) defines "taxable expenditures" subject to penalty excise taxes as including any amount paid by a private foundation "to carry on propaganda, or otherwise attempt, to influence legislation." For purposes of section 4945, the meaning of "propaganda, or otherwise attempt, to influence legislation" is similar to the definition of the term "influencing legislation" 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 (sec. 4945(e)).

President's Proposal

Businesses would no longer be allowed to deduct lobbying expenses. Lobbying expenses for this purpose would be defined similarly to the definition of expenditures to influence legislation in

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[14] Under this exception, the request for assistance or advice must be made in the name of the requesting governmental body, committee, or subdivision rather than an individual member thereof; and the response to such request must be made available to every member of the requesting body, committee, or subdivision. Treasury regulations further provide that because such assistance or advice may be given only at the express request of a governmental body, the oral or written presentation of such assistance or advice need not qualify as nonpartisan analysis, study or research. The offering of opinions or recommendations will ordinarily qualify under this exception only if such opinions or recommendations are specifically requested by the governmental body or are directly related to the materials so requested (Treas. Reg. secs. 56.4911-2(c)(3) and 53.4945-2(d)(2)).

section 4911(d) and would include attempts to influence legislation through communications with the executive branch as well as the legislative branch of government. The current restrictions on deductions for expenses of grassroots lobbying and participation in political campaigns would remain. These rules would prevent charities from engaging in more than an insubstantial amount of lobbying. No deduction would be allowed for the part of membership dues that are used for lobbying, but as under current law, trade associations and similar organizations would not lose their exempt status for lobbying. Trade associations and similar organizations would be required to report to their members the portion of their dues used for lobbying activities.

Effective Date

No effective date has been specified.

3. Require securities dealers to mark to market

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 (LCM); 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 LCM, 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, under generally accepted accpounting principles (GAAP), the inventory of securities generally is determined based on market value.

President's Proposal

The proposal would require securities dealers to compute their taxable income by marking their inventories of securities to market, as they already do when preparing financial statements in accordance with GAAP. Any gain or loss recognized under the mark-to-market method would generally be treated as ordinary gain or loss.

Each dealer that currently uses the cost or LCM method of accounting for its inventory of securities would be required to change to the mark-to-market method.

Effective Date

The dealer would be required to value its inventory of securities at market for all taxable years ending on or after December 31, 1993. Under a transitional rule, the resulting change in inventory value would be included in taxable income ratably over a 5-year period. For example, a dealer that uses a calendar year and that is required to change from the LCM method to the mark-to-market method for the year ending December 31, 1993, would increase its taxable income for 1993 and each of the next 4 years by 20 percent of the difference between the values of its inventory at market and at LCM as of the beginning of 1993.

Prior Action

H.R. 4210 and H.R. 11, as passed by the Congress in 1992 and vetoed by President Bush, contained similar provisions. A similar provision was contained in President Bush's fiscal year 1993 budget 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) [15], 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.

[15] 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)). The 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.

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 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.[16]

President's Proposal

The proposal would treat FSLIC assistance with respect to any loss as compensation for that loss for purposes of section 165 of the Code. FSLIC assistance with respect to any debt would be taken into account in determining the worthlessness of that debt for purposes of sections 166, 585 and 593 of the Code. FSLIC assistance would be defined as assistance provided with respect to domestic building and loan associations pursuant to section 406(f) of the National Housing Act or section 21A of the Federal Home Loan Bank Act.

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[16] 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.

Effective Date

The proposal would apply to FSLIC 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 the purpose of determining the amount of any net operating loss carryover to a taxable year ending on or after March 4, 1991. For this purpose, 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.

Prior Action

A similar provision was included in H.R. 11 and H.R. 4210 as passed by the Congress in 1992 and vetoed by President Bush. A similar provision also was included in the fiscal year 1993 budget proposal.

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 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 (the "100 percent of last year's liability safe harbor"). 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.

President's Proposal

The proposal would permanently extend the 97-percent requirement applicable for estimated tax payments based on a corporation's current year tax liability or its liability based on annualized income. The proposal would not alter 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.

Prior Action

The present-law 97-percent and 91-percent requirements were added by the Unemployment Compensation Amendments of 1992. H.R. 11, as passed by the Congress in 1992 and vetoed by President Bush, would have increased these requirements to a 100-percent requirement for taxable years beginning after 1992.

6. Limit possessions credit to 65 percent of compensation

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 Code section 936 generally to eliminate the U.S. tax (including the alternative minimum tax) on certain foreign source income which is related to their operations in the possessions. Income exempt from U.S. tax under this provision includes income that is derived either from the active conduct of a trade or business within a U.S. possession or from certain investments in the possessions or in certain Caribbean Basin countries, which investments generate qualified possession source investment income.[17]

In order to qualify for the section 936 credit, a domestic corporation must satisfy two requirements. Under one requirement, the corporation must derive 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 second requirement, it must derive at least 80 percent of its gross income from sources within the possession during that same three-year period.

Three alternative rules relate to allocating income from intangible property between a possessions corporation and its U.S. shareholders. The general rule is to prohibit the possessions corporation from earning any return on intangible property. A taxpayer 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 possessions 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 possessions corporation's product area, multiplied by 110 percent of the proportion of its 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 possessions corporation is treated as owning under

[17] 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.

the cost sharing method, were the possessions corporation a foreign corporation.

The alternative elective rule for allocating income from intangible property between a possessions corporation and its U.S. shareholders is a "profit split" approach. This method generally permits allocation to the possessions corporation of no more than 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 possessions 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 possessions corporation is owned by a single domestic corporation, the possessions 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.

President's Proposal

The section 936 credit would be limited to 65 percent of the wages the possessions corporation pays to its employees in the possession. For this purpose, wages 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 amount of wages subject to federal social security withholding (currently $57,600). Related possessions corporations would be permitted to consolidate for purposes of determining their section 936 credit.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1993, except that, for 1994 and 1995, possessions corporations may elect to claim a reduced credit not linked to compensation. Under this alternative, the credit will be limited to 80 percent of the current law credit in 1994 and 60 percent in 1995.

C. Foreign Tax Provisions

1. Eliminate working capital exception for foreign oil and gas and shipping income

Present Law

Foreign tax credit limitations in general

Foreign tax credit limitations are computed separately for certain categories of income, including passive income, high withholding tax interest, financial services income, shipping income, dividends from each noncontrolled section 902 corporation, certain distributions from DISCs, FSCs, and former DISCs and FSCs, certain types of FSC income, and all other (i.e., "general basket") income. Passive income generally includes income which is of a kind which would be foreign personal holding company income as defined under Code section 954(c) (e.g., interest and dividends). These separate limitations generally prevent the cross-crediting of high foreign taxes on general basket income against the U.S. tax on passive income.

The separate foreign tax credit limitation for passive income was enacted in 1986 and replaced the prior law separate foreign tax credit limitation for passive interest income. Prior law excluded from the passive interest separate limitation category interest derived from any transaction which is directly related to the active conduct by the taxpayer of a trade or business in a foreign country. Regulations under prior law expressly treated certain types of interest from working capital as interest derived from a transaction which is directly related to the active conduct of a trade or business (Former Treas. Reg. sec. 1.904-4(b)). No such general working capital exception exists under the passive income definition as established in the 1986 Act. However, that definition excludes foreign oil and gas extraction income ("FOGEI"), foreign oil related income ("FORI"), and shipping income.[18]

Special limitation on credits for foreign extraction taxes

In addition to the foreign tax credit limitations that apply to all foreign tax credits, a special limitation is placed on foreign income taxes on income from oil and gas extraction. Under this special limitation, amounts claimed as taxes paid on FOGEI of a U.S. company qualify as creditable taxes (if they otherwise so qualify) only

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[18] Section 904(d)(2)(A)(iii)(IV) provides that the foreign tax credit limitation for passive income does not include foreign oil and gas extraction income as defined in section 907(c). Regulations promulgated under section 907 include in the definition of FOGEI certain interest earned on working capital (Treas. Reg. sec. 1.907(c)-1T(f)(3)).

Code section 954(b)(8) provides that income which is foreign base company oil related income (defined under sec. 954(g) to include FORI) is not considered foreign personal holding company income. Treas. Reg. sec. 1.907(c)-1(e)(3) includes in the definition of FORI interest income on working capital. Thus, such income is excluded from the passive foreign tax credit limitation under present law since it is not of a kind which would be foreign personal holding company income.

Similarly, income which is treated as foreign base company shipping income under section 954(f) is not considered foreign personal holding company income (sec. 954(b)(6)), and working capital interest income is treated as foreign base company shipping income under regulations (Treas. Reg. secs. 1.954-6(e)(2)(ii) and 1.955A-2(b)(2)(i)). Moreover, the foreign tax credit separate limitation provisions of the Code provide a special overlap rule under which income described in any other separate limitation category (in this case, the separate limitation for shipping income) is not considered passive income (sec. 904(d)(2)(A)(iii)(I) and (D)).

to the extent they do not exceed 34 percent of such extraction income. Foreign taxes paid in excess of that amount on such income are, in general, neither creditable nor deductible (unless a carryover provision applies).

Under regulations issued prior to the 1986 Act and still effective, the definition of FOGEI includes interest on bank deposits or on any other temporary investment which is not in excess of funds reasonably necessary to meet the working capital requirements and the specifically anticipated business needs of a taxpayer engaged in extraction activities (Treas. Reg. sec. 1.907(c)-1T(f)(3)). Thus, under current regulations, FOGEI includes what would generally be considered for foreign tax credit limitation purposes as passive income.

In general, the statutory FOGEI rules are intended to prevent the crediting of high foreign taxes on FOGEI against U.S tax on other types of foreign source income. However, if a taxpayer has both high-taxed FOGEI, and also FOGEI which bears little or no foreign income tax, such as interest income on working capital, the current rules permit high FOGEI taxes to be cross-credited against U.S tax on that interest income.

President's Proposal

The proposal would prevent the cross-crediting of foreign taxes on FOGEI, FORI, and shipping income by placing investment income related to these types of income in the passive category for foreign tax credit limitation purposes. In addition, the proposal would exclude passive income related to foreign oil and gas extraction from the computation of the FOGEI foreign tax credit limitation.

Effective Date

The proposal would apply to income earned in taxable years beginning after December 31, 1993.

2. Transfer pricing initiative

Present Law

Penalties for valuation misstatements

Valuation questions are frequently central to disputes between taxpayers and the IRS, including disputes involving section 482. Certain types of valuation misstatements are subject to penalty. 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 percent of the tax understatement (sec. 6662(h)).

As in the case of accuracy-related penalties generally under section 6662, no valuation misstatement penalty is imposed if it is shown that there was reasonable cause for the underpayment and that the taxpayer acted in good faith (see sec. 6664(c)). No valuation misstatement penalty is imposed if the portion of the underpayment for the taxable year attributable to substantial valuation mis-

statements does not exceed $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company).

The term "substantial valuation misstatement" includes three types of misstatement (sec. 6662(e)). It includes claiming on a tax return that the value of any property is 200 percent or more of the amount determined to be correct. The term "gross valuation misstatement" refers to three similar, but more extreme, forms of misstatement (sec. 6662(h)). It includes claiming on a tax return that the value of any property is 400 percent or more of the amount determined to be correct.

Misstatement penalties and section 482 adjustments

The two other types of substantial valuation misstatement and gross valuation misstatement are defined by provisions enacted in the Omnibus Budget Reconciliation Act of 1990. These provisions address certain cases involving transactions between persons under common ownership or control, as those terms are used in section 482.

Under the 1990 Act, a substantial valuation misstatement includes claiming a price for any property or services (or use of property), in connection with any transaction between persons described in section 482, that is 200 percent or more (or 50 percent or less) of the amount determined under section 482 to be the correct amount of the price.[19] In addition, under the 1990 Act there is a substantial valuation misstatement if the net section 482 transfer price adjustment for the taxable year exceeds $10 million.[20] The net section 482 transfer price adjustment is the net increase in taxable income for a taxable year resulting from adjustments under section 482 in the price for any property or services (or use of property).

Certain increases in taxable income resulting from section 482 adjustments are disregarded in determining whether a taxpayer's net section 482 transfer price adjustment exceeds the $10 million or $20 million thresholds. A net increase in taxable income attributable to a price redetermination is disregarded, for example, if it is shown that there was a reasonable cause for the taxpayer's determination of the price, and that the taxpayer acted in good faith with respect to the price (sec. 6662(e)(3)(B)(i)).[21]

Regulations under sections 482, 6662, and 6664: Final, temporary, and proposed

Current penalty regulations

There are no temporary or final regulations specifically addressed to the 1990 Act valuation misstatement penalties relating to section 482 adjustments. There is a final regulation under the

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[19] The analogous "gross valuation misstatement" is defined in the same terms, except for replacing "200" with "400" and replacing "50 percent" with "25 percent."

[20] The analogous "gross valuation misstatement" involves a net section 482 transfer price adjustment of $20 million.

[21] In addition, any portion of the net increase in taxable income attributable to a transaction solely between foreign corporations is disregarded (unless the treatment of that transaction affects the determination of any such foreign corporation's income from sources within the United States or taxable income effectively connected with the conduct of a trade or business in the United States).

reasonable cause/good faith exception that applies generally to all valuation misstatement penalties and other accuracy-related penalties under Code section 6662 (Treas. Reg. sec. 1.6664-4). Under this regulation, the determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. The most important factor is the extent of the taxpayer's effort to assess its proper tax liability. Circumstances that may or may not indicate reasonable cause and good faith are described in the regulation.

Proposed penalty regulations on net section 482 transfer price adjustments

In January 1993 the Treasury Department published a proposed regulation specifically addressed to the 1990 Act valuation misstatement penalty provisions (58 Fed. Reg. 5304 (Jan. 21, 1993)). The proposed regulation would provide exclusive rules for determining the circumstances in which reasonable cause and good faith would and would not reduce or eliminate penalties that would otherwise apply to net section 482 transfer price adjustments in excess of $10 million or $20 million.[22] By its terms, the proposed regulation would apply to taxable years beginning after April 21, 1993.

Under the proposed regulation, there are two elements to the reasonable cause and good faith exclusion from the definition of a net section 482 transfer price adjustment.[23] Both elements must be satisfied by the taxpayer to prevent imposition of the penalty.

The proposed regulations state that the first element is a reasonable effort by the taxpayer to accurately determine its proper tax liability. This determination must be made no later than the time the return is filed for the tax year, and documentation must be contemporaneous with that determination. The documentation must include an analysis indicating that the result was an arm's length result within the meaning of the regulations promulgated under section 482. It is presumed that the taxpayer did not make a reasonable effort to accurately determine its proper tax liability if it possesses contemporaneous documentation of how a transfer price was determined, but does not provide the documentation to the IRS within 30 days of an IRS request.

The second element of the reasonable cause and good faith exclusion is whether the taxpayer reasonably believed that its transfer pricing methodology produced an arm's length result. The proposed regulation states that the determination of whether the taxpayer has such a reasonable belief is made in light of the experience and knowledge of the taxpayer. Various factors are discussed that may be taken into account in making that determination.

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[22] These exclusive rules are contained in proposed Reg. sec. 1.6662-5(j)(5). According to the preamble to the proposed regulation, a net section 482 transfer price adjustment for which the rules of sec. 1.6662-5(j)(5) are *not* satisfied will also *not* satisfy the general reasonable cause and good faith exception under section 6664(c). 58 Fed. Reg. at 5305.

By contrast, the preamble indicates that a valuation misstatement involving a related party transfer price 200 percent or more (or 50 percent or less) of the amount determined under section 482 to be the correct price is subject to the general reasonable cause/good faith regulations under section 6664(c). In addition, according to the preamble, if such a valuation misstatement satisfies the reasonable cause and good faith exclusion provisions under proposed sec. 1.6662-5(j)(5), then the taxpayer will be considered to have acted with reasonable cause and good faith for purposes of the general rules.

[23] Prop. Reg. sec. 1.6662-5(j)(5), 58 Fed. Reg. at 5308.

Section 482 regulations

Final regulations under section 482 are in force, and have not been amended since 1988. In January 1993, however, the Treasury Department promulgated temporary regulations under section 482, generally effective for taxable years beginning after April 21, 1993. To the extent that these temporary regulations go into effect, they will amend aspects of the existing final section 482 regulations.

The temporary regulations would, for example, revise the circumstances under which taxpayers may use a method *not* specified in these regulations, in order to establish the arm's length consideration for a "controlled transaction"—a transaction between members of a commonly controlled group of taxpayers—involving the transfer of tangible or intangible property. (Any method *not* specified in the section 482 regulations has popularly been referred to in the past as a "fourth method," in light of the fact that many cases involve transactions for which the final regulations specify only three methods.)

Under the temporary section 482 regulations, a taxpayer may use such an unspecified method only if three conditions are satisfied (Treas. Reg. secs. 1.482-3T(e)(2) and 1.482-4T(d)(2)). First, the taxpayer must disclose the use of the method by attaching an appropriate disclosure statement to the timely filed U.S. income tax return for the taxable year of the controlled transaction. Second, the taxpayer must prepare contemporaneous supporting documentation setting forth (a) the specific analysis adopted, (b) an analysis of why the method used provides the most accurate measure of an arm's length price, and (c) the data supporting its application. Third, within 30 days of a written request, the taxpayer must furnish this documentation to the IRS district director.

President's Proposal

Section 6662(e) would be amended to provide that the reasonable cause and good faith exclusion will be satisfied if the taxpayer provides contemporaneous documentation demonstrating the application of one or more reasonable transfer pricing methodologies to the taxpayer's controlled transactions. In order for the application of transfer pricing methodologies to be reasonable, any procedural or other requirements imposed by section 482 regulations with respect to the application of such method must be observed and documented. For example, if adjustments required under a particular method were not made, the taxpayer's application of such method would not be reasonable. In addition, methods other than those specifically prescribed in the section 482 regulations may be reasonable if the taxpayer could establish that, at the time of the controlled transactions, the prescribed methods would not be likely to lead to an arm's length result, and that the method actually applied was likely to lead to such a result.

This legislative proposal would be supplemented by a transfer pricing enforcement initiative.

Effective Date

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

3. Allocate research and experimentation (R&E) expense to place of performance and treat royalties as passive income for purposes of foreign tax credit limitation

Present Law

In general

The United States exerts jurisdiction to tax all income, whether derived in the United States or elsewhere, of U.S. persons (e.g., U.S. citizens, residents, and corporations). Generally, the United States cedes the primary right to tax income derived from sources outside of the United States to foreign governments. Thus, the Code provides a credit against the U.S. income tax imposed on foreign source taxable income to the extent of foreign taxes paid on that income.

A fundamental premise of the U.S. foreign tax credit system is that foreign taxes should not offset the U.S. tax on U.S. source income. In order that the foreign tax credit will offset only the U.S. tax on the taxpayer's foreign source taxable income, a statutory limitation formula is prescribed in the Code. As described above, this foreign tax credit limitation is computed separately for certain categories of income, including passive income. As indicated above, these separate limitations typically prevent the cross-crediting of high foreign taxes on general basket income against the U.S. tax on types of foreign source income typically subject to low foreign taxes, such as 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, as defined in Code sec. 954(c), if earned by a controlled foreign corporation.[24] Foreign personal holding company income generally consists of interest, royalties, rents, dividends, annuities, net gains from sales of property which either gives rise to certain types of foreign personal holding company income or does not give rise to any income, net commodities gains, net foreign currency gains, and related party factoring income.

Rents and royalties are not foreign personal holding company income if received in the active conduct of a trade or business from unrelated persons (sec. 954(c)(2)(A)). 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 (sec. 954(c)(3)).

[24] See Item C.5., below, for a definition of "controlled foreign corporation" and related terms.

The high-tax kick-out

Passive income earned abroad sometimes bears relatively high, rather than low, effective rates of foreign tax. For example, royalties (which may or may not be included in foreign personal holding company income) are sometimes subject to high gross-basis withholding taxes. To ensure that the separate limitation for passive income segregates low-taxed income from high-taxed income as intended and that substantial averaging within the passive basket is avoided, a mechanical rule (the "high-tax kick-out") excludes high-taxed income from the passive basket (sec. 904(d)(2)(A)(iii)(III)). 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) (sec. 904(d)(2)(F)).

Look-through rules

Dividends, interest, rents, royalties, and subpart F income inclusions received from controlled foreign corporations by their U.S. shareholders generally are subject to the general limitation or to the various separate limitations (as the case may be) in accordance with look-through rules that take into account the extent to which the income of the controlled foreign corporation is itself subject to one or more of these limitations (sec. 904(d)(3)(A)). A dividend or a royalty received from a controlled foreign corporation by a U.S. shareholder of that corporation, for example, is not automatically treated as 100-percent passive income even if it is income of a kind which would be foreign personal holding company income if earned by another foreign corporation.

Interest, rents, and 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 (sec. 904(d)(3)(C)).

Allocation and apportionment of deductions

To implement properly the rules for computing the foreign tax credit (and for other purposes), it is necessary to divide the taxable income of a U.S. person claiming the foreign tax credit into U.S. source taxable income, foreign source taxable income in each applicable separate limitation category, and foreign source taxable income in the general foreign tax credit limitation category.

Foreign source taxable income in any limitation category equals foreign source gross income in that category less the expenses, losses and other deductions properly apportioned or allocated to that income. The Code generally contains only broad principles for allocation and apportionment of expenses among U.S. and foreign source gross income categories, leaving the Treasury Department to provide detailed rules.

A Treasury regulation issued in 1977, section 1.861-8, describes methods for allocating expenses between U.S. and foreign source income, including rules for the allocation of research expenses (see sec. 1.861-8(e)(3)). The portion of the regulation dealing with re-

search expenses sets forth more than one allowable method. Each of the allowable methods has elements of one or more of the following three approaches: a place-of-performance approach, which would allocate expenses to the place where the research occurs; a sales (or gross receipts) approach, which would apportion expenses based on the proportions of the taxpayer's sales receipts from different sources; and a gross income approach, which would apportion expenses based on the proportions of the taxpayer's gross income from different sources. The regulation generally allows 30 percent of deductible research expenses to reduce gross income from the source where over half of the taxpayer's total deductible research expenses are incurred, so long as the sales approach is used to apportion the remainder of research expenses.[25]

Since 1981, the research expense allocation regulation has been subject to a series of statutory temporary suspensions and modifications. The most recent temporary statutory provision was applicable generally for the first six months of the first taxable year beginning after August 1, 1991. For this purpose total research expenses for the year were deemed to be incurred evenly throughout the year.

For expenses deemed paid or incurred during the first six months of the year referred to above (other than amounts incurred to meet certain legal requirements, and thus allocable to one geographical source), 64 percent of U.S.-incurred research expenses were allocated to U.S. source income, and 64 percent of foreign-incurred research expenses were allocated to foreign source income. The remainder of research expenses were allocated and apportioned either on the basis of sales or gross income, but subject to the condition that if income-based apportionment was used, the amount apportioned to foreign source income could have been no less than 30 percent of the amount that would have been apportioned to foreign source income had the sales method been used.

For expenses deemed paid or incurred during the remainder of the year, the research expense allocation regulation applied.

On June 24, 1992, it was announced that the Treasury Department and the IRS had undertaken a review of the research expense allocation regulation, and that in light of this review, the IRS temporarily would not require that taxpayers apply the regulation (Rev. Proc. 92-56, 1992-28 I.R.B. 7, amplified by Rev. Proc. 92-69, 1992-36 I.R.B. 18). According to these Revenue Procedures, taxpayers would not be required to apply the regulation with respect to research expenses incurred during what would ordinarily be an 18-month transition period—that is, the last six months of the taxpayer's first taxable year beginning after August 1, 1991 and the immediately succeeding taxable year—provided that such deductions were allocated and apportioned in accordance with a method based on the temporary statutory provision, described above, applicable generally through the first six months of the first taxable year beginning after August 1, 1991. The Revenue Procedures stated that this transition method was not intended to suggest any

[25] For a more detailed description of the regulation, and of the temporary statutory research expense allocation rules referred to below, see Joint Committee on Taxation, *Description and Analysis of Tax Provisions Expiring in 1992* (JCS-2-92), January 27, 1992, pp. 23-59.

views about the proper allocation and apportionment of research expenses, and that it was intended solely to provide taxpayers with transition relief and to minimize audit controversy and facilitate business planning during the conduct of the regulatory review.

President's Proposal

The proposal would allocate R&E expense to the place of performance of the R&E. In addition, it would provide for the treatment of all foreign source royalty income as income in the separate foreign tax credit limitation category for passive income.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1993.

4. Enhance earnings stripping and other anti-avoidance rules

Present Law

Interest deductions in general

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. For example, the interest income of the recipient may be exempt from U.S. tax if the recipient is generally exempt under Code section 401 or section 501. As another example, the income may be exempt from U.S. tax if the recipient is a foreign person and either the Code imposes no tax or a treaty eliminates the U.S. tax that would otherwise apply under the Code.

Interest paid to certain related persons

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 Code provides 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 the amount of tax-exempt interest paid to related persons (sec. 163(j)). This provision, described in more detail below, is commonly referred to as the "earnings stripping" provision.

For this purpose, a taxpayer's adjusted taxable income generally is its taxable income computed without regard to net interest expense, net operating loss carryovers, or any deduction allowable for depreciation, amortization, or depletion, and computed with such other adjustments as are provided by regulations. A recipient is related to the payor of interest if the recipient and payor would be treated as related under the rules of section 267(b) or subject to the controlled partnership rules of section 707(b)(1).

If a treaty between the United States and any foreign country reduces, but does not eliminate, the 30-percent U.S. tax prescribed by the Code with respect to interest that the taxpayer pays to a related person, the interest is subject to disallowance in the same

proportion as the treaty's rate reduction (from the 30-percent statutory rate) bears to 30 percent.

In determining the tax-exempt status of any interest recipient, look-through rules apply to pass-through entities (such as partnerships, regulated investment companies and real estate investment trusts), such that the deduction limitation applies separately to the beneficial interest held by each owner, in accordance with the separate tax-exempt status of each owner. However, whether or not a payment to a pass-through entity is treated as a payment to a person related to the U.S. corporation is generally determined at the entity level.

In the case of corporations that form part of an affiliated group (whether or not such corporations file a consolidated return), the earnings stripping limitation generally applies on a group basis.

Any amount of interest disallowed is permitted to be carried forward as disqualified interest to the following taxable year. In addition, a taxpayer is permitted to carry forward any excess limitation from its three most recent taxable years. The term excess limitation means the excess (if any) of 50 percent of the adjusted taxable income of the corporation over the corporation's net interest expense.

A corporation's interest deductions for a taxable year are not limited under the earnings stripping provision unless the ratio of debt to equity of the corporation as of the close of the taxable year (and on such other days during the taxable year as regulations may prescribe) exceeds 1.5 to 1. The ratio of debt to equity means the ratio which the total indebtedness of the corporation bears to the sum of its money and all other assets, reduced (but not below zero) by such total indebtedness, taking into account such adjustments as the Secretary may prescribe in regulations. For this purpose, the amount taken into account with respect to any asset is that asset's adjusted basis for purposes of determining gain.

The legislative history of the Omnibus Budget Reconciliation Act of 1989, which added the earnings stripping rules to the Internal Revenue Code, included the following language in the conference report's Statement of Managers:

> Some have argued that the House report's discussion of parent-guaranteed debt would potentially have made ordinary third-party financing transactions subject to the disallowance rule, in view of the common practice of having parents guarantee the debt of their subsidiaries in order to reduce the cost of third-party borrowings. The conferees intend to clarify that the provision is not to be interpreted generally to subject third-party interest to disallowance under the rule whenever such a guarantee is given in the ordinary course. On the other hand, the conferees do not intend to preclude Treasury from disallowing interest on a guaranteed third-party debt, in appropriate circumstances where the use of guaranteed third-party debt is a device for avoiding the operation of the earnings stripping rules,

just as Treasury is not precluded from disallowing interest on a back-to-back loan.[26]

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 the parent corporation.

President's Proposal

Any loan from an unrelated lender that is guaranteed by a related party would be treated as related party debt for purposes of the earnings stripping rules. Except as provided in regulations, a guarantee would be defined to include any arrangement under which a person directly or indirectly assures (on an unconditional or contingent basis) the payment of another's obligation. For purposes of determining whether the interest paid on the guaranteed debt is exempt from United States tax, the fact that the unrelated lender is subject to net basis United States taxation (as opposed to United States withholding tax) on its interest income would not be taken into account.

Other provisions would be adopted to prevent the use of back-to-back loans and other tax avoidance arrangements. These provisions would apply beyond the earnings stripping rules.

Effective Date

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

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

Present Law

In general

As described above, U.S. persons generally are taxed currently by the United States on their worldwide income. 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 to its U.S. stockholders. In both cases U.S. tax on foreign source income may be reduced by credits for foreign income taxes.

The Code sets forth several regimes providing exceptions to the general rule deferring U.S. tax on foreign income earned indirectly through a foreign corporation. One such regime applies only to certain substantial U.S. shareholders in U.S.-controlled foreign corporations. Other regimes apply to other U.S. persons owning stock in

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[26] House Rept. No. 101-386, 101st Cong., 1st Sess. 567 (1989). The conference report reference to back-to-back loans echoes language in the House Report on the 1989 Act:

> Under current law, back-to-back loans that have no substance are collapsed. See Rev. Rul. 84-152, 1984-2 C.B. 381, Rev. Rul. 84-153, 1984-2 C.B. 383, and Rev. Rul. 87-89, 1987-2 C.B. 195. The bill directs the Secretary to issue such regulations as may be appropriate to prevent the avoidance of the purposes of the bill. The committee intends that such regulations will treat back-to-back loans through third parties (whether related or unrelated), as well as similar arrangements, like direct loans to related parties.

House Rept. No. 101-247, 101st Cong., 1st Sess. 1246 (1989).

predominantly "passive" foreign corporations. Still other regimes are primarily applicable to U.S. persons owning stock in domestic corporations, but also can be applied to U.S. persons owning stock in foreign corporations.

Controlled foreign corporations

Under the controlled foreign corporation rules of subpart F (secs. 951-964), a controlled foreign corporation (CFC) is defined generally as any foreign corporation if U.S. persons own more than 50 percent of the corporation's stock, taking into account only so-called "U.S. shareholders": namely, those U.S. persons that own (directly, indirectly or by attribution) at least 10 percent of its voting stock (sec. 957).

A "U.S. shareholder," so defined, may be taxed currently by the United States on its proportionate share of the controlled foreign corporation's "subpart F income." 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. Subpart F income consists of foreign base company income, insurance income, and certain income relating to international boycotts and other violations of public policy.

In addition to taxation of subpart F income and taxation of actual repatriations of earnings not already taxed as subpart F income, a U.S. shareholder may also be subject to U.S. taxation on the controlled foreign corporation's current or accumulated earnings (other than subpart F income), at the time of any increase for the year in the amount of those earnings invested by the controlled foreign corporation in certain U.S. property. Thus, for example, assume that a controlled foreign corporation has an active foreign manufacturing business. It earns no subpart F income and has no U.S. property. It has $100 of accumulated earnings, all of which are invested in the foreign business. Assume that in the current year the foreign corporation disposes of $50 worth of foreign business assets and places the proceeds in a U.S. real estate investment or lends them to its U.S. shareholders. In either case, the U.S. shareholders are taxed on $50 in the current year.

Earnings and profits of a controlled foreign corporation that are (or previously have been) included in the incomes of the U.S. shareholders (either as subpart F income or as investments of earnings in U.S. property) are not taxed again when such earnings are actually distributed to the U.S. shareholders (sec. 959(a)(1)). Similarly, such previously taxed income is not included again in the incomes of the U.S. shareholders in the event that such earnings are invested in U.S. property (sec. 959(a)(2)). Distributions by a controlled foreign corporation are allocated first to previously taxed income, then to other earnings and profits (sec. 959(c)). Therefore, a controlled foreign corporation may distribute its previously taxed income to its shareholders, resulting in no additional U.S. income taxation, before it makes any taxable dividend distributions of any current or accumulated earnings and profits.

Passive foreign investment companies

If any foreign corporation (including a controlled foreign corporation) is a so-called "passive foreign investment company" (PFIC),

U.S. persons (including 10-percent "U.S. shareholders") that own stock in the PFIC may be subject to one of two other sets of operating rules that eliminate or reduce the benefits of deferral (secs. 1291-1297). 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 (sec. 1296(a)).

Under the tax rules applicable at the election of a U.S. person owning PFIC stock, the U.S. person includes 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. As under the controlled foreign corporation rules, the distribution of earnings and profits that were previously included in the income of an electing shareholder under these rules is not treated as a dividend to the shareholder (sec. 1293(c)). 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 dividends distributed by the PFIC or capital gains from selling PFIC stock), the nonelecting U.S. person must pay an additional interest charge. This interest charge is related to the value of delaying income realization, and therefore delaying tax, by investing indirectly in assets through the vehicle of a foreign corporation.

Accumulated earnings tax

In addition to the corporate income tax, the Code also imposes a tax, at the rate of 28 percent, on the accumulated taxable income of any corporation (with certain exceptions) formed or availed of for the purpose of avoiding income tax with respect to its shareholders (or the shareholders of any other corporation), by permitting its earnings and profits to accumulate instead of being distributed (secs. 531, 532(a)). The specified tax-avoidance purpose generally is determined by the fact that the earnings and profits of the corporation are allowed to accumulate beyond the reasonable needs of the business (sec. 533). The accumulated earnings tax acts as a substitute for the tax that would have been incurred by the shareholders on dividends actually distributed by the corporation.

The accumulated earnings tax does not apply to certain specified types of corporations, including PFICs (sec. 532(b)). These exceptions, along with the current inclusion of subpart F income in the gross incomes of the U.S. shareholders of a controlled foreign corporation, have resulted, in practice, in very limited application of the accumulated earnings tax to foreign corporations.

President's Proposal

The proposal would require 10 percent United States shareholders of certain CFCs to include in income currently their pro rata shares of a specified portion of the CFC's current and accumulated earnings. The proposal would apply to a CFC (including a CFC that is a PFIC) holding passive assets representing 25 percent or more of the value of the CFC's total assets. The portion of current and accumulated earnings subject to inclusion ("includible earnings")

would be the lesser of (1) total current and accumulated earnings and profits, or (2) the amount by which the value of the CFC's passive assets exceeds 25 percent of the value of its total assets. Includible earnings would be adjusted to account for amounts previously taxed. For this purpose, passive assets would be defined as under the PFIC rules (including the definition of passive income thereunder).

Effective Date

The proposal generally would be effective for taxable years beginning after December 31, 1993. Under a phase-in rule, the amount subject to current inclusion would be limited to the 10-percent United States shareholder's pro rata share of the applicable percentage of includible earnings (20 percent in 1994, 25 percent in 1995, 35 percent in 1996, 50 percent in 1997, and 100 percent in 1998 and thereafter).

D. Energy Tax Provisions

1. BTU energy tax

Present Law

No comprehensive energy tax is imposed under present law. Excise taxes are imposed on motor fuels (gasoline, special motor fuels, and diesel fuel) used for highway transportation, special motor fuels used in motorboats, diesel fuel used in trains, and aviation fuel used in noncommercial aviation. Further, excise taxes are imposed on coal from domestic mines and on crude oil received at domestic refineries and petroleum products entered into the United States. With the exception of the motor fuels tax, current energy-related excise taxes are relatively minor revenue items. For the most part, these revenues are deposited in various trust funds to finance specific Federal public works, environmental, or benefit programs. The motor fuels tax also has a deficit reduction portion (2.5 cents per gallon) that is not dedicated, but is retained in the General Fund (see, also item D.2., below).

President's Proposal

The proposal would impose an excise tax on fossil fuels (coal, oil, natural gas) at a basic rate of $0.257-per-million-Btus plus a $0.342-per-million-Btus supplemental tax on oil. The tax would also be imposed on alcohol fuels (ethanol and methanol produced, other than from fossil fuels, for use as a fuel). The tax would be imposed on hydro-and nuclear-generated electricity, and on imported electricity at a rate equal to the national average of tax embedded in electricity generated from fossil fuel. Additionally, the tax would be imposed on imported taxable products at a rate equal to the average tax imposed on equivalent domestic products. All tax amounts would be indexed for general inflation after 1997. A single national average of BTU content would be used for oil, gas, and alcohol fuels, while actual Btu content would be used for coal. Nonconventional fuels (including solar, geothermal, biomass, and wind), exported taxable products, and non-fuel uses of fossil and alcohol fuels (including coke and feedstocks) would be exempt.

The collection point for the tax would be the refinery for oil, the pipeline for natural gas, the minemouth for coal, the production facility for alcohol fuels, the utility for hydro- and nuclear-generated electricity, and the importation point for imported electricity and imported taxable products. Exemptions or downstream credits would be provided for nonfuel use and exports.

Effective Date

The tax at one-third of the rates specified above would be imposed beginning July 1, 1994; two-thirds beginning July 1, 1995; and the full rates beginning July 1, 1996. An appropriate delay in the phase-in of the supplemental tax on oil would be provided in the case of home heating oil.

2. Extend General Fund motor fuels excise tax rate

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, 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 is also 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 motor fuels tax revenues are transferred to the Highway Trust Fund through September 30, 1999.

President's Proposal

The proposal would extend the 2.5-cents-per-gallon deficit reduction rate permanently. The proposal would retain current-law exemptions.

Effective Date

The extension of the deficit reduction rate would apply after September 30, 1995.

Prior Action

The 2.5-cents-per-gallon deficit reduction rate was adopted as part of the Omnibus Budget Reconciliation Act of 1990.

E. Compliance Provisions

1. Reporting rule for service payments to corporations

Present Law

A person engaged in a trade or business who makes payments of $600 or more to a person for services performed during the calendar year 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)).[27]

President's Proposal

The proposal would require that annual payments by a payor of $600 or more for services purchased in the course of the payor's trade or business be reported to the IRS by a payor for all service providers, including corporations.

Effective Date

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

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 [28] 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) the item was adequately disclosed on the tax return (or a statement attached to the return), provided that the treatment of the disclosed item 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 sub-

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[27] 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.

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

stantiate 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)) [29] .

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 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 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 by adequate disclosure of the position claimed on the return or claim if the position is not "frivolous" (Treas. Reg. secs. 1.6694-2(c), 1.6694-3(c)) [30].

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

President'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.

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[29] 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.

[30] 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.

Effective Date

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

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 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)).

President's Proposal

The proposal would strengthen the requirements for reducing the amount of an understatement in the case of tax shelter items. 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 tax benefits from the shelter did not significantly exceed the reasonably anticipated pre-tax economic profit from the shelter (over the reasonably anticipated life of the shelter).

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 tax benefits from the shelter did not significantly exceed the reasonably anticipated pre-tax economic profit from the shelter.

Effective Date

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

F. Miscellaneous Provisions

President's Proposal

The Administration's proposals incorporate certain items from H.R. 11 (the Revenue Act of 1992), including provisions that would require substantiation and disclosure relating to charitable contributions, expand the 45-day interest free period for certain refunds, deny the travel deduction for spouses, and increase the applicable withholding rate on bonuses to 28 percent.

Prior Action

H.R. 11, as passed by the Congress in 1992 and vetoed by President Bush, included the following provisions which are similar to the Administration's proposals: (1) section 7202, which would have imposed certain substantiation and information disclosure requirements relating to charitable contributions; (2) section 3201, which would have expanded the 45-day interest free period for certain refunds; (3) section 3007, which would have generally denied the travel deduction for spouses and dependents; and (4) section 3202, which would have increased the applicable withholding rate on certain supplemental wage payments (such as bonuses, commissions and overtime pay) to 28 percent.

III. ADDITIONAL REVENUE PROPOSALS

A. Increase Taxable Portion of Social Security Benefits

Present Law

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

Proceeds from the income taxation of these benefits are credited quarterly to the Old-Age and Survivors Insurance Trust Fund, the Disability Trust Fund, or the Railroad Retirement Trust Fund, as appropriate.

President's Proposal [31]

The Administration proposes including up to 85 percent of benefits in adjusted gross income, for those with income and benefits exceeding the current law $25,000/$32,000 thresholds.

Effective Date

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

[31] The description of this proposal is from the OMB document, *A Vision of Change for America*, February 7, 1993, p.101.

B. Other Tax-Related Provisions

1. 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.

President's Proposal [32]

The proposal would increase the 1994 Federal inland waterway fuel tax from 19 cents to $1.19 per gallon in a series of increasing steps to a total of $1.00.

Effective Date

The proposal would be effective beginning in 1994.

Prior Action

The inland waterway fuel tax was adopted originally as part of the Inland Waterways Revenue Act of 1978 and the rate schedule was last increased as part of the Water Resources Development Act of 1986.

2. Use of Harbor Maintenance Trust Fund amounts 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 (currently scheduled to expire after September 30, 1995).[33]

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[32] The description of this proposal is from the OMB document, *A Vision of Change for America*, February 17, 1993, p. 76.

[33] A separate Administration proposal (not described in this pamphlet) would permanently extend the Customs processing fee. (See OMB document, *A Vision of Change for America*, February 17, 1993, p. 83.)

President's Proposal [34]

The proposal would provide up to $5 million annually from the Harbor Maintenance Trust Fund for the Department of the Treasury (Customs Service) to improve compliance with the existing harbor maintenance excise tax.

Effective Date

Not specified.

Prior Action

A similar provision was included in H.R. 11, as passed by the Congress in 1992 and vetoed by President Bush. A similar provision also was included in H.R. 5100, as passed by the House in 1992 (see H. Rept. 102-607), and in H.R. 5643, as reported by the Senate Committee on Finance in 1992 (see S. Rept. 102-430).

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[34] The description of this proposal is from the OMB document, *A Vision of Change for America*, February 17, 1993, p. 78.

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