Carol Rasco

THE WHITE HOUSE

WASHINGTON

January 4, 1994

The attached document is background for tomorrow's NEC meeting, to be held from 5:00–6:00 p.m. in Room 248 of the OEOB.

This document contains some sensitive information and your careful handling is appreciated. Thank you.

Sylvia Mathews, NEC

Attachment

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

December 28, 1993

MEMORANDUM FOR BOB RUBIN

FROM: **LLOYD BENTSEN** LB

SUBJECT: **FY 1995 BUDGET PROPOSALS -- EXPIRING TAX PROVISIONS**

SUMMARY: The targeted jobs tax credit (TJTC), exclusion for employer-provided educational assistance, and the orphan drug tax credit expire on December 31, 1994. The R&E tax credit and the R&E 50-percent allocation rule expire mid-year in 1995. If the President wishes to propose the extension of some or all of these provisions, such proposals should be included in the FY 1995 budget submission to the Congress. This memorandum describes each of the expiring provisions and provides you with a recommendation regarding how long these provisions should be extended.

RECOMMENDATION: Because of revenue constraints and other factors set forth below, I recommend that the President propose a package consisting of either a (1) one year extension of the exclusion for employer-provided educational assistance and the orphan drug credit (**$491 million** over 5 years), with a commitment to study the R&E credit, 50-percent R&E allocation, and TJTC and to consider including a revised version of these provisions in the FY 1996 budget or (2) one year extension of all the expiring provisions (**$3.2 billion**).

Either of these two approaches would, as I believe we should, minimize the number of tax increases in the budget (which will be necessary to pay for extending the expiring provision under the pay-go rules). During an election year, both Democrats and Republicans are likely to oppose another round of tax increases particularly after the enactment of the 1993 Budget Act. It is also important to keep in mind that at some time next year we will have to propose ways to finance the GATT--Uruguay Round (approximately $11 billion over 5 years), Generalized System of Preferences ($2.7 billion), unemployment insurance extended benefits program ($3.3. billion), the dislocated workers program ($5 billion), and welfare reform ($20 billion). I would note that a package of permanent extensions of the expiring provisions would cost in excess of **$14 billion** over 5 years.

The first of the two alternatives I recommend excludes the R&E credit, 50-percent R&E allocation rule and TJTC. Since the R&E provisions expire in mid-1995, we could defer this issue and include both of these provisions in the FY 1996 budget. In addition, several proponents of the credit (i.e., Senators Baucus and Danforth and Rep. Pickle) have proposed a number of modifications to the credit rules. We would like to evaluate these proposals before proposing to further extend the credit. In addition, the Department of Labor recently issued a report which indicates that the TJTC may be an ineffective and inefficient tax subsidy. Thus, the first alternative also excludes this credit. In 1994, we would review this credit with the Labor Department to determine if the credit should be restructured or allowed to expire.

The second alternative, which would extend all five of the expiring provisions for one year, would cost **$3.2 billion** over 5 years. This proposal would provide for the minimal possible extension of the expiring provisions in 1994 so as to ensure that the provisions would not have to be extended retroactively at some point in 1995.

DISCUSSION:

1. In General. The provisions expiring before the end of FY 1995 are as follows:

December 31, 1993	• Health insurance deduction for self-employed individuals
December 31, 1994	• Targeted jobs tax credit • Exclusion for employer-provided educational assistance • Orphan drug tax credit
June 30, 1995	• R&E tax credit
July 30, 1995	• R&E 50-percent allocation rule

The Administration's FY 1994 budget proposed permanent extensions of these provisions but the political support for permanent extension was tepid at best. The final 1993 deficit reduction bill included permanent extension of the low-income housing credit, the mortgage revenue bond program, small-issue industrial development bonds, and alternative minimum tax (AMT) relief for charitable contributions of appreciated property.

2. Specific Provisions

Health insurance deduction for self-employed individuals. The extension of this provision is included in the health care proposal. The proposal in the health care bill permanently extends and increases the deduction from 25 percent to 100 percent. This proposal loses **$9.8 billion** over 5 years.

TJTC. The TJTC provides a maximum credit of $2,400 per employee to employers that hire individuals who are recipients of payments under means-tested transfer programs, economically disadvantaged or disabled. The Labor Department is responsible for overseeing state programs to certify eligible recipients.

A recent study by Labor's Inspector General analyzed the effectiveness of the TJTC in Alabama. This study found that most of the workers hired by companies would have been hired without the credit. Many employers taking the credit do not know at the time a job offer is extended if the individual will qualify for the credit. In addition, some employers are reluctant to ask the questions necessary to determine eligibility because of privacy concerns and a fear of discrimination suits by applicants who do not receive job offers. Thus most of the work is delegated to TJTC consultants. The Inspector General is currently conducting a nationwide study, which is expected in June of 1994.

Despite these problems the TJTC has strong support on Capitol Hill (i.e., from Senators Boren and Baucus and Rep. Rangel). Because of the ongoing study and concerns recently raised by Labor's report we believe that a viable option is that an extension of the credit not be proposed at this time and that a study of the TJTC be undertaken during 1994. In addition, Labor is interested in developing tax incentives to encourage worker training, youth apprenticeships, etc. We also need time to determine if they are viable proposals and, if so, whether they should supplement or replace the TJTC.

A permanent extension loses **$1.3 billion** over 5 years and a one year extension loses **$307 million** over 5 years.

Employer-provided educational assistance. An employee may exclude the first $5,250 of educational assistance paid for or provided by the employer during the taxable year pursuant to an educational assistance program. The exclusion is not limited to job-related educational assistance, but does not apply to any education involving sports, games, or hobbies. A permanent extension loses **$2.5 billion** over 5 years and a one year extension loses **$467 million** over 5 years. Senator Moynihan is a strong supporter of this provision.

Orphan drug credit. The orphan drug credit is a 50% nonrefundable tax credit for expenses incurred in the testing of drugs for certain rare diseases. A rare disease is a disease that (1) affects less than 200,000 persons in the U.S. or (2) affects more than 200,000 persons but for which there is no reasonable expectation that businesses could recoup the costs of developing a drug for it from U.S. sales of the drug (e.g., Lou Gehrig's disease, Tourette's syndrome, etc.). Last year's budget did not include a proposal to extend this credit because this was considered a health care issue. The credit, however, was included in the final 1993 budget bill. The Administration's health care proposal does not propose to extend the credit. We, therefore, recommend that it be included in the budget. A permanent extension loses **$124 million** over 5 years and a one year extension loses **$24 million** over 5 years.

R&E credit. The President and I have consistently endorsed a permanent R&E credit. In the past, however, revenue constraints have forced Congress to settle for temporary extensions. The credit expires on June 30, 1995 (i.e., several months after the presentation of the FY 1996 budget). Consequently, we have to decide whether to include the extension in the FY 1995 or FY 1996 budget. If it is decided to defer extension to the FY 1996 budget, it would be appropriate to study a number of issues regarding the structure and efficacy of the credit during 1994. For example, many argue that the current method of computing the credit denies the credit to deserving businesses. The credit is available only for incremental research expenses in excess of a base amount. The base amount is determined based on data from the 1983-1988 period, and thus may not reflect the current circumstances of many businesses. Other issues have been raised by recent proposals involving enhanced incentives for collaborative research, and use of the credit to ease defense conversion by making the credit available to companies converting from high technology defense businesses to civilian businesses that may be relatively less research-intensive. These and other proposals were included in a bill introduced earlier this year by Senator Danforth.

In contrast to those who would enhance the credit and improve its incentive effects, others question whether any research credit is justifiable. In particular, Rep. Rostenkowski has long been skeptical of the efficacy of the credit. He was one of the proponents of the reduction in the credit from 25 to 20 percent of incremental research expenditures as part of the Tax Reform Act of 1986.

Finally, a long-term extension of the credit would be difficult to finance. Permanent extension of the credit loses **$7.6 billion** over 5 years. Thus, a permanent extension would require us to propose a package of significant revenue raisers. A one year extension would lose **$1.8 billion** over 5 years.

<u>R&E allocation</u>. In 1977, Treasury regulations were issued that required U.S. multinationals to allocate between foreign and domestic source income the amount of their research and experimentation expenses (the apportionment in general was according to the proportion of foreign and domestic sales or gross income). The effect of requiring U.S. multinationals to allocate some of their R&E deductions to foreign income, even though the R&E may have been entirely performed in the U.S., was to cause some U.S. multinationals to lose foreign tax credits. Viewing this result as undercutting the tax incentive for R&E, the Congress imposed a moratorium on the 1977 regulations, and has extended this moratorium nine times since 1977, the last time in OBRA '93. The OBRA '93 moratorium provision provided that 50 percent of R&E expense could be allocated to U.S. income before apportionment. It expires July 31, 1995. A permanent extension of the OBRA '93 moratorium would lose **$2.8 billion** over 5 years and a one-year extension would lose **$568 million** over 5 years.

Despite urging from the Congress to provide a 50 percent or better R&E allocation rule **by regulations** (which would spare the Congress the necessity of paying for an extension), our judgment (and that of the previous Administration) is that the Treasury lacks the statutory authority to provide a tax **incentive** for R&E by regulations. Our authority is limited to an allocation rule that matches R&E expenses with the income produced by those expenses. We therefore believe that a 50-percent (or higher percentage) rule must be accomplished by legislation. If the R&E credit is extended, we believe that the R&E allocation rule should also be extended. On the other hand, if the R&E credit extension is deferred to the FY 1996 budget we suggest that the R&E allocation rule also be deferred and studied during 1994.