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**General Explanations  
of the  
President's Budget Proposals  
Affecting Receipts**



**Department of the Treasury  
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## CAPITAL GAINS TAX RATE REDUCTION FOR INDIVIDUALS

The Administration proposes that the capital gains tax rate for individuals be reduced on long-term investments by enacting a sliding scale exclusion for long-term capital gains. The proposal provides for a 10, 20, or 30 percent exclusion for long-term capital gains on assets held by individual taxpayers for one, two or three years, respectively. The three year holding period requirement will be phased in over three years.

The reduction in capital gains taxes would benefit all Americans by providing incentives for saving and investment that will result in higher national output and more jobs.

### Current Law

Under current law, capital gains of individuals are taxed at the same rates as ordinary income. Capital gains are thus generally subject to a 15 percent, 28 percent, or 33 percent marginal tax rate. When capital gains taxes interact with other provisions in the income tax code, such as the floors under itemized deductions for medical and miscellaneous expenses, the phase-outs of IRA deductions, and the exclusion of Social Security income, the marginal tax cost of an asset may be even higher in some cases.

While the Tax Reform Act of 1986 eliminated the capital gains exclusion, it did not eliminate the legal distinction between capital gains and ordinary income or between short-term and long-term capital gains. Capital assets include any property except inventories or other items held for sale in the ordinary course of business, depreciable and real property used in a trade or business, copyright, literary, musical and artistic compositions, and certain other listed assets. Examples include real estate and antiques. Gains or losses from the sale or exchange of capital assets held for one year or longer are classified as long-term capital gains or losses.

Individuals with capital losses exceeding capital gains may generally apply up to \$3,000 of such losses as a deduction against ordinary income. A net capital loss in excess of the deduction limitation may be carried forward. Special rules allow individuals to treat losses of up to \$50,000 (\$100,000 on a joint return) with respect to stock in certain small business corporations as ordinary losses without regard to the \$3,000 limit.

Depreciation recapture rules recharacterize a portion of capital gains on depreciable property as ordinary income. These rules vary for different types of depreciable property. For personal property, all previously allowed depreciation not in excess of the realized capital gain is generally recaptured as ordinary income. For real property using straight-line depreciation, there is no depreciation recapture if the asset is held

at least one year. For real property acquired before 1987, generally only the excess of the depreciation claimed in excess of depreciation as calculated under the straight-line method is recaptured as ordinary income. There are also recapture rules applicable to the disposition of depletable property and to certain other assets.

Capital gains and losses are generally taken into account when "realized" upon the sale, exchange, or other disposition of the asset. Certain dispositions of capital assets, such as transfers by gift, are not generally realization events for income tax purposes. In general, in the case of gifts, the donor does not realize gain or loss and the donor's basis in the property carries over to the donee. In certain cases, such as the gift of a bond with accrued market discount or of property that is subject to indebtedness in excess of the donor's basis, the donor may recognize ordinary income upon making a gift. The capital gain in a charitable contribution of appreciated property is included as a preference item in calculating the alternative minimum tax. Gain or loss is not realized on a transfer at death, and the beneficiary's basis in the inherited asset is generally the fair market value of the asset at (or near) the date of death.

#### Reasons for Change

Restoring a capital gains tax rate differential is essential to promote savings, entrepreneurial activity, and risky investment in new products, processes, and industries that will help keep America competitive and economically strong. At the same time, investors should be encouraged to extend their horizons and search for investments with longer-term growth potential. The future competitiveness of this country requires a sustained flow of capital to innovative, technologically advanced activities that may generate minimal short-term earnings but promise strong future profitability. A preferential tax rate limited to longer-term commitments of capital will encourage business investment patterns that favor innovations and long-term growth over short-term profitability. The resulting increase in national output would benefit all Americans by providing jobs and raising living standards.

In addition to the improvements in productivity and economic growth, a lower rate on long-term capital gains would also improve the fairness of the individual income tax by providing a rough adjustment for the taxation of inflationary gains that do not represent any increase in real income. In addition, it provides relief from the double taxation of investments in corporate stock.

Incentives for Longer-Range Investment. A capital gains preference has long been recognized as an important incentive for capital investment. The first tax rate differential for capital gains in this country was introduced by the Revenue Act of 1921. For the next 65 years there was always some tax rate differential

for long-term capital gains. The preferential treatment for capital gains has taken various forms including an exclusion of a fixed portion of the nominal gains, an exclusion that depended on the length of time a taxpayer held an asset, and a special maximum tax rate for capital gains. But at no time after 1921 and before 1987 were long-term capital gains ever taxed at the same rates as ordinary income. Figure 1 shows that the average effective tax rate on realized capital gains is now higher than it has ever been.

By eliminating the capital gains exclusion and lowering tax rates on ordinary income, the 1986 Act increased the incentives for short-term trading of capital assets. This occurred because the tax rate on long-term capital gains was increased while the tax rate on short-term capital gains was reduced. By providing for a sliding scale exclusion that provides full benefits only for investments held at least 3 years after a phase-in period, the proposal will reduce the incentive for short-term trading.

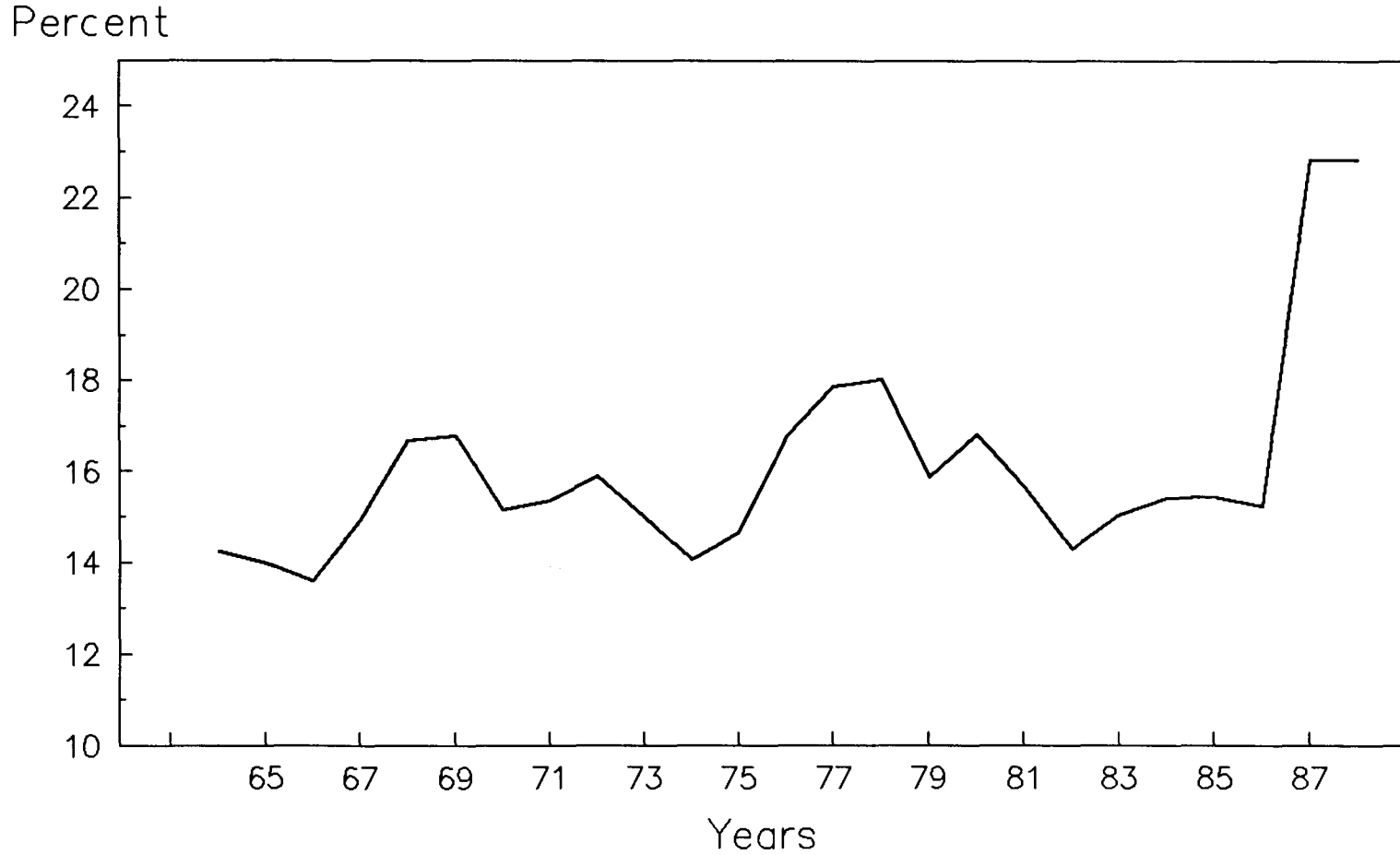
The Cost of Capital and International Competitiveness. The capital gains tax is an important component of the cost of capital, which measures the pre-tax rate of return required to induce businesses to undertake new investment. Evidence suggests that the cost of capital in the United States is higher than that in many other industrial nations. While not solely responsible for the higher cost of capital, high capital gains tax rates hurt the ability of U.S. firms to obtain the capital needed to remain competitive. By reducing the cost of capital, a reduction in the capital gains tax rate will stimulate productive investment and create new jobs and growth.

Our major trading partners already recognize the economic importance of low tax rates on capital gains. Virtually all other major industrial nations provide lower tax rates on capital gains (or do not tax capital gains at all). Canada, France, Germany, Japan, the Netherlands, and the United Kingdom (among others), all treat capital gains preferentially.

The Lock-In Effect. Under a tax system in which capital gains are not taxed until realized by the taxpayer, a substantial tax on capital gains tends to lock taxpayers into their existing investments. Many taxpayers who would otherwise prefer to sell their assets to acquire new better investments may instead continue to hold onto the assets rather than pay the current high capital gains tax on their accrued gains.

This lock-in effect of capital gains taxation has at least three adverse effects. First, it produces a misallocation of the nation's capital stock and entrepreneurial talent because it alters the investment decisions that would be made in a genuinely free market. For example, the lock-in effect reduces the ability of entrepreneurs to withdraw from an enterprise and use the funds to start new ventures. Productivity in the economy suffers because entrepreneurs are less likely to move to where they can

FIGURE 1.  
AVERAGE EFFECTIVE TAX RATE ON CAPITAL GAINS  
1964-1987



Department of the Treasury  
Office of Tax Analysis

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be most productive, and because economic resources may be used in a less productive fashion rather than transferred to other, more efficient, enterprises. These effects can be especially critical for smaller firms, which may not have good access to capital markets and where ownership and operation frequently go together. Second, the lock-in effect produces distortions in the investment portfolios of individual taxpayers. For example, some individual investors may be induced to assume more risk than they desire because they are reluctant to sell appreciated investments to diversify their portfolios. Third, the lock-in effect reduces government receipts. To the extent that taxpayers defer sales of existing investments, or hold onto investments until death, taxes that might otherwise have been paid are deferred or avoided altogether. Therefore, individual investors, the government, and other taxpayers lose from the lock-in effect. The investor is discouraged from pursuing more attractive investments and the government loses revenue.

Substantial evidence from more than a dozen studies demonstrates that high capital gains tax rates in previous years produced significant lock-in effects. The importance of the lock-in effect may also be demonstrated by the fact that realized capital gains were 16 percent lower under the high tax rates in 1987 than under the lower rates in 1985, even though stock prices had risen by approximately 50 percent over this period. The high tax rates on capital gains under current law imply that the lock-in effect is greater than at any prior time. (See Figure 1).

Penalty on High Risk Investments. Full taxation of capital gains, in combination with limited deductibility of capital losses, discourages risk-taking. It therefore impedes investment in emerging high-technology and other high-growth firms. While many investors are willing to take risks in anticipation of an adequate return, fewer are willing to contribute "venture capital" if a significant fraction of the increased reward will be used merely to satisfy higher tax liabilities. A tax system that imposes a high tax rate on gains from the investment reduces the attractiveness of risky investments, and may result in many worthwhile projects not being undertaken.

In particular, it is inherently more risky to start new firms and invest in new products and processes than to make incremental investments in existing firms and products. It is therefore the most dynamic and innovative firms and entrepreneurs that are the most disadvantaged by the current high capital gain tax rates that penalize risk-taking. Such firms have traditionally been contributors to America's edge in international competition and have provided an important source of new jobs.

Double Tax on Corporate Stock Investments. Under the U.S. income tax system, income earned on investments in corporate stock is generally subjected to two layers of tax. Income on corporate investments is taxed first at the corporate level at a rate of 34 percent. Corporate income is taxed a second time at

the individual level in the form of taxes on capital gains and dividends at rates ranging from 15 to 33 percent. The combination of corporate and individual income taxes thus can produce effective tax rates that are substantially greater than individual income tax rates alone. To the extent the return to the investor is obtained through appreciation in the value of the stock (rather than through dividend income), a reduction in capital gains tax rates provides a form of relief from this double taxation of corporate income. While a lower capital gains tax rate reduces the cost of capital for both corporate and non-corporate business, the greater liquidity of shares in publicly-traded companies suggests that the overall effect would be to reduce the bias towards noncorporate business that results from our dual-level tax system.

### Description of Proposal

General Rule. The capital gains tax rate will generally be lower than the tax rate on ordinary income. Individuals would be allowed to exclude a percentage of the capital gain realized upon the disposition of qualified capital assets. The amount of the exclusion would depend on the holding period of the assets. Assets held 3 years or more would qualify for an exclusion of 30 percent. Assets held at least 2 years but less than 3 years would qualify for a 20 percent exclusion. Assets held at least 1 year but less than 2 years would qualify for a 10 percent exclusion. As a result of the exclusion, the tax rate applicable to capital gains on qualified assets held for at least 3 years would be 19.6 percent for a taxpayer in the 28 percent tax bracket. Similarly, investments held by such taxpayer between 2 and 3 years would be taxed at a 22.4 percent rate, and assets held between 1 and 2 years would be taxed at a 25.2 percent rate. Individuals in the 15 percent tax bracket would pay proportionally lower rates of tax (13.5 percent, 12.5 percent, and 10.5 percent, respectively).

Qualified assets would generally be defined as any assets qualifying as capital assets under current law and satisfying the holding period requirements, except for collectibles. Collectibles are assets such as works of art, antiques, precious metals, gems, alcoholic beverages, and stamps and coins. Assets eligible for the exclusion would include, for example, corporate stock, manufacturing and farm equipment, a home, an apartment building, a stand of timber, or a family farm.

Phase-in Rules and Effective Dates. The proposal would be effective generally for dispositions of qualified assets after the date of enactment. For the balance of 1990, the full 30 percent exclusion would apply to assets held at least one year. For dispositions of assets in 1991, assets would be required to have been held for 2 years or more to be eligible for the 30 percent exclusion, and at least one year but less than 2 years to be eligible for the 20 percent exclusion. For dispositions of assets in 1992 and thereafter, assets would be required to have

been held at least 3 years to be eligible for the 30 percent exclusion, at least 2 years but less than 3 years for the 20 percent exclusion and at least 1 year but less than 2 years for the 10 percent exclusion.

Additional Provisions. The excluded portion of capital gains would be added back in when calculating income under the alternative minimum tax. Installment sale payments received after the effective date will be eligible for the exclusion without regard to the date the sale actually took place. For purposes of the investment interest limitation, only the net capital gain after subtracting the excluded amount would be included in investment income.

Depreciation deductions taken with respect to all depreciable property would be recaptured in full as ordinary income. This provision prevents taxpayers from benefiting from the exclusion provision for depreciation deductions that have already been claimed in prior years. To the extent that depreciable assets have increased in value above their unadjusted basis, taxpayers would be able to benefit from the exclusion.

#### Examples of the Effects of the Proposal

Example A. Taxpayer A is a single individual earning \$16,000 whose mutual fund investments have a reported long-term capital gain of \$500 in 1990.

Under current law, her tax on the \$500 capital gain would be 15 percent of the full \$500 gain or \$75.00.

Under the proposal, her tax would be reduced to \$52.50 which is 15 percent of \$350 (\$500 less 30 percent exclusion).

Example B. Example B is a two-earner couple with combined taxable income other than capital gains of \$90,000. In 1992 they sell corporate stock, realizing a \$1,500 capital gain on stock held 15 months and a \$2,300 capital gain on stock held 5 years.

Under current law both gains are subject to full taxation at an effective tax rate of 33 percent. Tax on the \$1,500 gain would be \$495 and tax on the \$2,300 gain would be \$759, for a combined tax of \$1,254.

Under the proposal, the gain from the sale of stock held 15 months would be eligible for a 10 percent exclusion and the stock held 5 years would be eligible for a 30 percent exclusion. The tax on the stock held 15 months would be \$445.50 and the tax on the stock held 5 years would be \$531.30 for a combined tax of \$976.80, 22 percent lower than under current law.

Example C. Taxpayer C is the founder of a five year old computer software company who would like to sell the company in order to start a new company making a new product. Taxpayer C

has a salary of \$180,000 and \$20,000 in dividend and interest income. Taxpayer C sells the stock in the computer software company for \$2 million, resulting in a capital gain of \$1.8 million after deduction of the \$200,000 cost basis.

Under current law, Taxpayer C would pay a capital gains tax of 28 percent, or \$504,000, leaving him with net proceeds of \$1,496,000 from the sale of the company.

Under the proposal, the capital gains tax would be \$352,800 or 28 percent of \$1,260,000 (\$1,800,000 less 30 percent exclusion). The net proceeds from the selling the company would now be \$1,647,000. Taxpayer C has an additional \$151,200 that can be invested in the new business.

### Issues Raised by Critics

Criticism of a reduction in capital gains tax rates has centered on two main issues: the benefits to high income taxpayers and the effects on tax reform.

A number of tables have been published which show that the benefits of a reduction in capital gains tax rates would go primarily to high-income taxpayers. These tables often classify taxpayers by their total current income, including capital gains. This has the effect of counting middle-income taxpayers who realize a one-time capital gain (such as the sale of their home) as "high-income", thereby overstating the concentration of capital gains in high-income classes. The tables imply that the benefits of a capital gains tax reduction are highly skewed toward high-income taxpayers. Because they own more capital assets, many high-income taxpayers will clearly benefit from lower capital gains taxes. They do not, however, represent the largest group of beneficiaries. In a typical year, 15 million tax returns (representing approximately 25 million taxpayers) report income from the sale of capital assets. Furthermore, it is estimated that nearly one half of all taxpayers report capital gains in one year or another during their life.

It is widely agreed that taxpayers will increase their level of realizations of capital gains in response to a reduction in capital gains tax rates. Our analysis shows that this increase in realizations is sufficiently large that more taxes will be paid in response to the Administration's proposed capital gains tax reduction. Thus, high-income taxpayers will pay more taxes following the reduction in capital gains tax rates. Further, the best available evidence indicates that high-income taxpayers are more responsive to reductions in capital gains tax rates than are lower-income taxpayers. This means that the share of total income taxes paid by higher-income taxpayers will also increase in response to a reduction in capital gains tax rates.

A capital gains tax reduction is likely to be a "win-win" situation for taxpayers at all income levels. High-income taxpayers are better off because of the lower capital gains tax rates, even though they actually pay more in taxes. Lower and middle-income taxpayers are also better off because of lower taxes on the capital gains which they realize, but in addition will benefit from the deficit reduction and programs that can be funded by the additional capital gains tax revenues. All taxpayers also benefit from the enhanced economic productivity and growth which results from a reduction in capital gains tax rates. The benefit to the U.S. economy is the most important issue with respect to a capital gains tax reduction, and these benefits are shared by all.

Another criticism of a capital gains rate cut is that a lower rate for capital gains would threaten tax reform and result in a new proliferation of tax shelters. Prior to tax reform, 60 percent of long-term capital gains on assets held at least 6 months were excluded. Under the new Administration proposal, the maximum exclusion rate is 30 percent. Because of the smaller exclusion rate, depreciation recapture, and the alternative minimum tax, there is little danger of a resurgence of tax shelters. In addition, other rule changes under tax reform, such as the limits on the deduction of passive losses, also protect the tax system against tax shelter abuses.

#### Revenue Estimates

Capital gains realizations are highly volatile over time in response to changes in stock prices and general economic conditions. All Treasury revenue estimates of capital gains since 1978 have taken into account expected changes in taxpayer behavior. In particular, taxpayers are assumed to adjust their purchases and sales of capital assets and their other income sources in response to the new tax rules.

These behavioral effects are the subject of continued empirical research. Treasury's Office of Tax Analysis incorporates all effects believed to be important and presents its best estimate of the expected effects. The proposal is expected to increase Treasury receipts as compared to current law receipts due to increased realizations. The revenue estimates noted below assume a March 15, 1990 effective date. The increase in revenues is expected to be greatest in fiscal year 1991 due to the unlocking of existing capital gains, and smaller thereafter. All of the expected changes in revenues are modest in comparison to the magnitude of the expected annual capital gains tax revenues (slightly in excess of \$40 billion).

These estimates do not include the effects of potential increases in long-run economic growth expected from a lower capital gains tax rate. This conforms to the standard budget and revenue estimating practice of assuming that the macroeconomic effects of revenue and spending proposals are already included in the economic forecast.

Even under these restrictive revenue estimating conventions, Treasury's projections indicate that the Administration proposal would produce increased revenues not only through the budget period, but for the foreseeable future. It is important to note that a lower capital gains tax rate should stimulate additional investment. Such increases in the overall economy would generate additional capital gains revenue in the longer term.

	Fiscal Years						Total
	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1990-</u> <u>1995</u>
	(Billions of Dollars)						
Capital gains tax rate reduction:	0.5	4.9	2.8	1.2	1.7	1.4	12.5

## FAMILY SAVINGS ACCOUNTS

### Current Law

Taxation of Investment Income and Saving. Investment income earned by an individual taxpayer is generally subject to tax. The funds saved out of each year's income, which are used to make additional deposits to savings or other investment accounts, additional purchases of stocks or bonds, or to acquire other investments, are generally not deductible in calculating taxable income. The major exception is the tax treatment of retirement savings, for which contributions are generally deductible and investment earnings are excludable from income, and thus not taxed, until distributed.

Individual Retirement Accounts. The current law for Individual Retirement Accounts (IRAs) grants married taxpayers who do not participate in a qualified retirement plan or who have adjusted gross incomes (AGI) below \$50,000 the right to make deductible contributions to an IRA. There is a lower income threshold of \$35,000 if the taxpayer is unmarried (or is married but does not file a joint return). The deductibility of contributions for taxpayers participating in a qualified retirement plan is phased out as their AGI ranges from the last \$10,000 below the income threshold to the threshold. Taxpayers who do participate in a qualified retirement plan and who have adjusted gross incomes above these thresholds may make only nondeductible contributions to an IRA. Both deductible and nondeductible IRA contributions are limited to the lesser of \$2,000 or the individual's compensation for the year.

Married individuals who both work and otherwise qualify may each contribute to an IRA, so if both have compensation of \$2,000 or more, they may jointly contribute \$4,000 to an IRA. If only one spouse works, qualifying married individuals also have the opportunity to contribute an additional \$250 to a spousal IRA for the nonworking spouse. The limit on deductible contributions to a spousal IRA is proportionately reduced for adjusted gross incomes in the applicable phase-out ranges.

Withdrawals from an IRA prior to age 59-1/2 are generally subject to a 10 percent additional tax. Except for distributions of amounts which were not deductible when contributed, IRA withdrawals are subject to regular income tax, and withdrawals must begin by age 70-1/2.

Deductible IRAs effectively exempt investment income from taxation. (The income tax imposed on withdrawals merely recaptures the tax saved from deducting the contribution, plus interest on that tax savings; the investment income itself is exempt from tax.) This favorable tax treatment provides an incentive to save; IRAs are designed to provide this incentive specifically for retirement savings. The tax exemption of

investment income is also a feature of 401(k) and similar retirement plans. Nondeductible IRAs allow only a deferral of taxes on investment income, not an exemption.

### Reasons For Change

There is general concern that the rate of national saving and investment is too low relative to that needed to sustain future growth and to maintain our relative economic position in comparison with the performance of other industrial nations. Addressing this problem requires that both public dissaving (the budget deficit) be reduced, and that private saving be increased. Incentives provided by the proposed Family Savings Accounts will provide an important incentive to encourage private saving.

The availability of tax exempt savings accounts in the form of IRAs was sharply curtailed by the Tax Reform Act of 1986, which resulted in a large decline in IRA participation. Prior to the Act, any individual under the age of 70-1/2 could make deductible contributions, up to the current limits, to an IRA. One of the goals of the current proposal is to restore, and in several ways expand, the availability and attractiveness of tax exempt saving to a large segment of the population.

An additional goal of the current proposal is to expand savings incentives to income that is saved for other than retirement purposes, while not eroding incentives for retirement saving. The proposal recognizes that individuals save for many reasons: for down-payments on homes, for educational expenses, for large medical expenses, and as a hedge against uncertain income in the future.

### Description of Proposal

The Family Savings Account (FSA) differs from a deductible current law IRA in two respects: the contributions are not deductible, but if the account is maintained for at least seven years, neither the contributions nor the earnings are taxed when withdrawn. As in the case of IRAs, the income would not be taxed when earned. The proposal would allow individuals (other than dependents) to make nondeductible contributions to a FSA of the lesser of \$2,500 or the individual's compensation for the year. Contributions would be allowed for single filers with adjusted gross income (AGI) less than \$60,000, for heads of households with AGI less than \$100,000, and for married taxpayers filing joint returns with AGI less than \$120,000. Contributions to FSAs would be allowed in addition to contributions to current law qualified pension plans, IRAs, 401(k) plans, and other tax-favored forms of saving.

Earnings on contributions retained in the FSA for at least seven years would be eligible for full tax exemption upon withdrawal. However, withdrawals of earnings allocable to contributions retained in the FSA for less than three years would be



subject to both a 10 percent excise tax penalty and to income tax. Withdrawals of earnings allocable to contributions retained in the FSA for three to seven years would be subject only to income tax. The effective date would be January 1, 1990.

Effects of the Proposal

The proposal would increase the total amount of individual saving that can earn tax free investment income. Generally, individuals would be able to contribute to FSAs, IRAs, 401(k) plans, and similar tax-favored plans and receive tax exemption on the investment income from each source.

The ability to contribute to an FSA would significantly raise the total amount of allowable contributions to tax-favored savings accounts. The contribution limit is \$5,000 for joint return filers as compared to the \$4,000 IRA limit for a working couple with sufficient compensation. These higher total contribution limits will provide additional marginal incentives for personal saving. The higher eligibility limits on FSAs also expand the incentives to more taxpayers.

Despite the difference in structure, the value of the tax benefits in present value of an FSA per dollar of contribution is equivalent in terms of its tax treatment to the value of current law deductible IRAs, assuming that tax rates are constant over time. Both FSAs and deductible IRAs effectively exempt all investment income from tax. The contributions to FSAs are not deductible, but the income tax imposed on withdrawals from an IRA effectively offsets the tax savings from the deduction of the contribution (plus interest on the tax savings). Individuals who expect higher tax rates when the funds are withdrawn would generally prefer the tax treatment offered in an FSA to that in an IRA. Conversely, individuals who expect lower future tax rates would generally prefer an IRA as a vehicle for retirement savings. However, the Family Savings Account offers more flexibility, because full tax benefits are available seven years after contribution and the account need not be held until retirement. This gives individuals an added degree of liquidity.

Revenue Estimate

	Fiscal Years						Total
	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1990-</u> <u>1995</u>
	(Billions of Dollars)						
Family savings accounts:	*	-.2	-.6	-1.0	-1.3	-1.6	-4.7

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\* Revenue loss less than \$50 million.



## PENALTY-FREE IRA WITHDRAWALS FOR FIRST-TIME HOME BUYERS

### Current Law

Married taxpayers who do not participate in a qualified retirement plan or who have adjusted gross incomes below \$50,000 may make deductible contributions to an Individual Retirement Account (IRA). There is a lower threshold of \$35,000 for unmarried taxpayers and for married taxpayers who file a separate return. The deductibility of contributions for taxpayers participating in a qualified retirement plan is phased out over the last \$10,000 below the income threshold for each income tax filing status. Taxpayers who do participate in a qualified retirement plan and who have adjusted gross incomes above these thresholds may make only nondeductible contributions to an IRA. Both deductible and nondeductible IRA contributions are limited to the lesser of \$2,000 or the individual's compensation for the year. Married individuals may contribute an additional \$250 to a spousal IRA for a nonworking spouse.

Withdrawals from IRAs must begin by age 70-1/2. IRA withdrawals, except those from nondeductible contributions, are subject to income tax. Withdrawals from an IRA prior to age 59-1/2 are subject to a 10 percent additional tax.

### Reasons For Change

The intent of this proposal is to expand savings incentives to income that is saved for first-time home purchases. Increased flexibility of IRAs would help to alleviate the difficulties that many individuals have in purchasing a new home.

The attractiveness of IRAs for many taxpayers was sharply curtailed by the Tax Reform Act of 1986. This resulted in a large decline in IRA participation. Prior to the Act, any individual under the age of 70-1/2 could make deductible contributions, up to the current limits, to an IRA. The current proposal is designed to enhance the attractiveness of deductible IRAs by making them more flexible. This increased flexibility would provide an incentive for more taxpayers to save for the purchase of their home.

### Description of Proposal

The proposal would allow individuals to withdraw amounts of up to \$10,000 from their IRAs for a "first-time" home purchase. The 10 percent additional tax on early withdrawals would be waived for eligible individuals. Eligibility for penalty-free withdrawals would be limited to individuals who did not own a home in the last three years and are purchasing or constructing a principal residence that costs no more than 110 percent of the median home price in the area where the residence is located. The effective date of the proposal would be January 1, 1990.

Effects of the Proposal

This proposal will help encourage individuals to save for the purchase of a first home.

Revenue Estimate

Fiscal Years

	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	Total <u>1990-</u> <u>1995</u>
	(Billions of Dollars)						
Penalty-free IRA withdrawals for first time home buyers:	-*	-*	-.1	-.1	-.1	-.1	-.4

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-\* Revenue loss of less than \$50 million.

## PERMANENT RESEARCH AND EXPERIMENTATION TAX CREDIT

### Current Law

Present law allows a 20 percent tax credit for a certain portion of a taxpayer's "qualified research expenses." The portion of qualified research expenses that is eligible for the credit is the increase in the current year's qualified research expenses over its base amount for that year. The base amount for the current year 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. A taxpayer's fixed-base percentage generally is the ratio of its total qualified research expenses for the 1984-88 period to its total gross receipts for this period. Special rules for start-up companies provide a fixed-base percentage of .03. In no event will a taxpayer's fixed-base percentage exceed .16. A taxpayer's base amount may not be less than 50 percent of its qualified research expenditures for the current year.

In general, qualified expenditures consist of (1) "in-house" expenditures for wages and supplies used in research; (2) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf; and (3) certain time-sharing costs for computers used in research. Restrictions further limit the credit to expenditures for research that is technological in nature and that will be useful in developing a new or improved business component. In addition, certain research is specifically excluded from the credit, including research performed outside the United States, research relating to style, taste, cosmetic, or seasonal design factors, research conducted after the beginning of commercial production, research in the social sciences, arts, or humanities, and research funded by persons other than the taxpayer.

The credit is available only for research expenditures paid or incurred in carrying on a trade or business of the taxpayer. A taxpayer is treated as meeting the trade or business requirement with respect to in-house research expenses if, at the time such in-house research expenses are incurred, the principal purpose of the taxpayer in making such expenditures is to use the results of the research in the active conduct of a future trade or business of the taxpayer or certain related taxpayers.

Present law also provides a separate 20 percent tax credit ("the University Basic Research Credit") for corporate funding of basic research through grants to universities and other qualified organizations performing basic research. The University Basic Research Credit is measured by the increase in spending from certain prior years. This basic research credit 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 fixed research floor plus an amount reflecting any decrease in nonresearch giving to

universities by the corporation as compared to such giving during a fixed base period (adjusted for inflation). A grant is tested first to see if it constitutes a basic research payment; if not, it may be tested as a qualified research expenditure under the general R&E credit.

The R&E credit is aggregated with certain other business credits and made subject to a limitation based on tax liability. The sum of these credits may reduce the first \$25,000 of regular tax liability without limitation, but may offset only 75 percent of any additional tax liability. Taxpayers may carry credits not usable in the current year back three years and forward fifteen years.

The amount of any deduction for research expenses is reduced by the amount of the tax credit taken for that year.

The R&E credit in the form described above is in effect for taxable years beginning after December 31, 1989. However, the credit will not apply to amounts paid or incurred after December 31, 1990, and a special rule applies in the case of any taxable year which begins before August 2, 1990, and ends after September 30, 1990. Under this rule, the amount treated as a taxpayer's qualified research expenses for the taxable year is pro-rated by the ratio of the number of days in the taxable year before October 1, 1990, to the total number of days in the taxable year before January 1, 1991. By limiting the amount of eligible expenses, this rule is intended to provide the equivalent of a nine-month extension of the R&E credit.

#### Reasons for Change

The current law tax credit for research provides an incentive for technological innovation. Although the benefit to the country from such innovation is unquestioned, the market rewards to those who take the risk of research and experimentation may not be sufficient to support the level of research activity that is socially desirable. The credit is intended to reward those engaged in research and experimentation of unproven technologies.

The credit cannot induce additional R&E expenditures unless its future availability is known at the time firms are planning R&E projects and projecting costs. R&E activity, by its nature, is long-term, and taxpayers should be able to plan their research activity knowing that the credit will be available when the research is actually undertaken. Thus, if the R&E credit is to have the intended incentive effect, it should be made permanent.

#### Description of Proposal

The R&E credit would be made permanent, and the special tax rule which limits the amount of eligible expenses during 1990 would be deleted.

Effects of Proposal

Stable tax laws that encourage research allow taxpayers to undertake research with greater assurance of the future tax consequences. A permanent R&E credit (including the University Basic Research Credit) permits taxpayers to establish and expand research facilities without fear that the tax incentive would not be available when the research is carried out.

Revenue Estimate

	Fiscal Years					
	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>
	(Billions of Dollars)					
Permanent R&E tax credit:	-0.1	-0.5	-0.9	-1.1	-1.3	-1.6





## RESEARCH AND EXPERIMENTATION EXPENSE ALLOCATION RULES

### Current Law

The tax credit allowed for payments of foreign tax is limited to the amount of U.S. tax otherwise payable on the taxpayer's income from foreign sources. The purpose of this limitation is to prevent the foreign tax credit from offsetting U.S. tax imposed on income from U.S. sources. Accordingly, a taxpayer claiming a foreign tax credit is required to determine whether income arises from U.S. or foreign sources and to allocate expenses between such U.S. and foreign source income.

Under the above limitation rules, an increase in the portion of a taxpayer's income determined to be from foreign sources will increase the allowable foreign tax credit. Therefore, taxpayers generally receive greater foreign tax credit benefits to the extent that their expenses are applied against U.S. source income rather than foreign source income.

Treasury regulations issued in 1977 described methods for allocating expenses between U.S. and foreign source income. Those regulations contained specific rules for the allocation of research and experimentation (R&E) expenditures, which generally required a certain portion of R&E expense to be allocated to foreign source income. Absent such rules, a full allocation of R&E expense to U.S. source income would overstate foreign source income, thus allowing the foreign tax credit to apply against U.S. tax imposed on U.S. source income and thwarting the limitation on the foreign tax credit.

Since 1981 these R&E allocation regulations have been subject to six different suspensions and temporary modifications by Congress. The Technical and Miscellaneous Revenue Act of 1988 ("TAMRA") adopted allocation rules which were in effect for only four months. For twenty months following the period when the TAMRA rules were in effect, R&E allocation was controlled by the 1977 Treasury regulations. The Budget Reconciliation Act of 1989 (the "1989 Act") subsequently reintroduced the TAMRA rules, once again on a temporary basis.

Under the R&E allocation rules enacted by TAMRA (and temporarily recodified by the 1989 Act), a taxpayer must allocate 64 percent of R&E expenses for research conducted in the United States to U.S. source income and 64 percent of foreign-performed R&E to foreign source income. The remaining portion can be allocated on the basis of the taxpayer's gross sales or gross income. However, the amount allocated to foreign source income on the basis of gross income must be at least 30 percent of the amount allocated to foreign source income on the basis of gross sales.

Under the 1989 Act, these R&E allocation rules are effective for the taxpayer's first taxable year beginning after August 1, 1989 and before August 2, 1990; except that the rules apply only to the portion of R&E expenses treated (on an annualized basis) as having been paid or incurred during the first nine months of that taxable year.

#### Reasons for Change

Permanent R&E expense allocation rules are essential for U.S. companies to plan accurately the long-term costs of their R&E programs. After more than ten years of instability, both the U.S. government and the affected taxpayers have a strong interest in ending this controversy through the adoption of a fixed allocation system applicable to R&E.

In addition, as evidenced by its continued support for a permanent R&E credit, the Administration believes in the provision of tax incentives to increase the performance of U.S.-based research activities. The allocation rules in this proposal provide such an incentive. Although the proposal benefits only multinational corporations that are subject to the foreign tax credit limitation, it will provide an effective incentive with respect to such entities. By enhancing the return on R&E expenditures, the proposal promotes the growth of overall R&E activity as well as encouraging the location of such research within the United States.

#### Description of Proposal

The proposal would adopt on a permanent basis the R&E allocation rules which were first enacted by TAMRA and were re-enacted by the 1989 Act. The proposal would be effective for all taxable years beginning after August 1, 1990.

#### Effects of Proposal

Under the proposal, the automatic allocation of 64 percent of U.S.-performed R&E to U.S. source income generally permits a greater amount of income to be classified as foreign source than the rules applicable under the 1977 regulations. As discussed above, this will increase the benefits of the foreign tax credit for many taxpayers.

The operation of these rules is best illustrated through an example. Assume that an unaffiliated U.S. taxpayer has \$100 of expense from research performed in the United States, that 50 percent of relevant gross sales produce foreign source income, and that 30 percent of the taxpayer's gross income is from foreign sources. Subject to certain limitations not applicable to these facts, the 1977 regulations would have required the taxpayer to allocate at least \$30 of R&E expense to foreign source income ( $\$100 \times 30\%$  gross income from foreign sources).

Under the proposal, \$64 is automatically allocated to U.S. source income based on the place of performance (\$100 x 64%). The remaining \$36 may be allocated either on the basis of gross sales or on the basis of gross income (subject to the limitation described below). A gross sales apportionment of the remainder would result in \$18 (\$36 x 50%) being allocated to foreign source income, while a gross income apportionment would result in \$10.80 (\$36 x 30%) being allocated to foreign source income.

The amount allocated to foreign source income using the gross income method must be at least 30 percent of the amount so allocated using the gross sales method. That limitation will not affect the result here since the \$10.80 apportioned to foreign source income under the gross income method is greater than \$5.40 (\$18 apportioned under gross sales x 30% limitation).

As a result of the allocation rules in the proposal, the taxpayer in this example must allocate at least \$10.80 of U.S.-performed R&E expense to foreign source income, compared to the \$30 required to be so allocated under the 1977 regulations.

Effects of the Proposals

This reduction of foreign allocated expenses would result in an increase of overall foreign source income and, for many taxpayers, greater foreign tax credit benefits. This may stimulate increased U.S. investment abroad.

Revenue Estimate

	Fiscal Years					
	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>
	(Billions of Dollars)					
Permanent R&E expense allocation:	0	-0.4	-0.7	-0.8	-0.8	-0.9



## ENERGY TAX INCENTIVES

### Current Law

Summary. Current law provides incentives for domestic oil and gas exploration and production by allowing the expensing of intangible drilling costs ("IDCs") and the use of percentage depletion. These two incentives are subject to certain limitations and their benefits are included as preferences in the alternative minimum tax ("AMT"). The cost of injectants used in tertiary enhanced recovery projects may also be deducted. Current law does not provide any further tax incentives for either exploratory drilling or tertiary enhanced recovery techniques.

Exploratory Drilling vs. Development Drilling. The search for new oil and gas reserves typically begins with certain preliminary tests (e.g., geological and geophysical tests) designed to determine the likelihood of discovering commercial quantities of hydrocarbons. If such tests suggest that oil and gas may be present, further tests may be conducted. New oil and gas reserves, however, are typically identified only by exploratory drilling. About 55 percent of exploratory well drilling expenditures result in dry holes. A dry hole results if commercially recoverable oil and gas is not found. A taxpayer is allowed to expense all costs of a dry hole upon abandonment of the dry hole. If exploratory drilling is successful in locating oil and gas in commercial quantities, additional drilling, termed development drilling, is done to recover the maximum amount of oil and gas. Current law does not provide any distinct incentives for exploratory as compared to developmental drilling.

Tertiary Enhanced Recovery Techniques. Tertiary enhanced recovery techniques increase available reserves by producing oil and gas that cannot be recovered economically with conventional pumping or water flooding. Tertiary enhanced recovery projects use a variety of injectants, including steam, CO<sub>2</sub>, or chemical injectants.

Intangible Drilling Costs (IDCs). Current law generally requires the capitalization of expenditures for permanent improvements or betterments made to increase the value of any property. An exception to the capitalization requirement permits the expensing of IDCs paid in connection with the drilling of oil, gas, and geothermal wells. IDCs include amounts paid for labor, fuel, repairs, and site preparation. IDCs do not include geological and geophysical costs ("G&G costs") and surface casing costs (e.g., the cost of casings, valves, pipelines, and other facilities required to control, transport, or store the oil and gas). Costs that do not qualify as IDCs must be capitalized and recovered through depreciation or depletion.

Percentage Depletion. Cost recovery with respect to oil and gas properties is allowed by means of depletion deductions. The depletion deduction may be calculated under the cost

depletion method or, with significant restrictions, under the generally more favorable percentage depletion method. Under cost depletion, the amount of the depletion deduction is equal to the portion of the taxpayer's basis equal to the percentage of total oil or gas reserves produced during the year. Cost depletion deductions may not exceed the taxpayer's basis in the property.

Under percentage depletion, the amount of the depletion deduction is equal to a statutory percentage of gross income from the property (15 percent in the case of oil and gas production). Percentage depletion deductions over the life of a property may exceed the cost of the property. Independent producers and royalty owners may use percentage depletion, but only with respect to 1,000 barrels of production per day. Percentage depletion with respect to oil and gas is not permitted for retailers or refiners of oil or gas products. Percentage depletion is also unavailable for oil and gas properties that have been transferred after they have been "proven" (i.e., shown to have oil or gas reserves). The percentage depletion deduction may not exceed either 50 percent of the taxpayer's net income from the property or 65 percent of the taxpayer's net taxable income for the year.

Alternative Minimum Tax (AMT). An alternative minimum tax is imposed on certain taxpayers. This tax is calculated with respect to alternative minimum taxable income ("AMTI"), which is calculated by making certain adjustments and adding tax preference items to regular taxable income. Both IDCs and percentage depletion deductions are preference items for both corporate and noncorporate taxpayers, and thus are included in AMTI.

The percentage depletion tax preference item is the amount by which the depletion deduction claimed for regular tax purposes exceeds the taxpayer's basis in the property at the end of the taxable year (disregarding the depletion deduction for the year). Treating such amounts as a preference item in computing AMTI may reduce or eliminate the benefit of permitting percentage depletion for certain taxpayers.

The IDC tax preference is the amount by which a taxpayer's "excess IDCs" claimed with respect to successful wells exceed 65 percent of the taxpayer's net income from oil, gas, or geothermal properties. The "excess IDCs" are the amount by which the IDC deductions claimed for the year exceed the deductions that would have been claimed had the IDCs been capitalized and either amortized over 120 months or recovered through cost depletion. Thus, for AMT purposes, the IDC deduction for incremental IDC expenditures in excess of the net income limit is reduced to zero. Any amount of IDCs may be capitalized and amortized over a 60-month period by a special taxpayer election for both the regular tax and the AMT. This election eliminates the requirement for AMT adjustments with respect to such amounts.

Tertiary Injectants. A taxpayer is allowed to deduct an amount equal to the qualified tertiary injectant expenses of the taxpayer for tertiary injectants injected during the taxable year. A qualified tertiary injectant is defined as any tertiary injectant (other than a recoverable hydrocarbon injectant) which is used as part of a tertiary recovery method.

### Reasons for Change

The reduction in world oil prices and the increasing levels of oil imports over the last several years raise energy security concerns. While oil prices appear more recently to have firmed up, the nation's increased dependence on foreign oil still leaves the nation vulnerable to potential foreign supply disruptions. The Administration supports an energy policy that is designed to address these concerns by improving our long-term energy security and strengthening the domestic oil industry.

An increase in domestic oil and gas reserves would improve energy security. The level of proven domestic reserves is closely related to the level of domestic exploratory drilling, which has fallen by 70 percent from recent levels, largely due to uncertainty concerning low world oil prices. In addition, over the same time period, development drilling has increased 20 percent, resulting in a substantial decline in existing domestic oil and gas reserves. Special tax incentives are appropriate to encourage higher levels of exploratory drilling, which will ultimately may lead to increased domestic reserves.

Current law limits the incentive effects of IDC expensing and percentage depletion, particularly for independent producers, who have historically drilled a majority of exploratory wells. Current percentage depletion rules limit its use to properties acquired by, or transferred to, an independent producer before the property is shown to have oil or gas reserves (the "transfer rule"). This rule discourages the transfer of producing wells that are uneconomic in the hands of their current owners (and thus likely to be abandoned) to those who may be more efficient, more willing to bear current losses, or better able to use the depletion tax benefits (and thus able to continue operation of the property). By keeping marginal wells in production, U.S. oil production would be maintained without incurring additional drilling costs.

Current law also provides that percentage depletion may not exceed 50 percent of the net income of a property calculated before depletion. The 50 percent net income limitation may significantly reduce the benefits of percentage depletion for production from properties generating a small amount of net income. Raising the net income limitation to 100 percent would allow some oil producers to claim greater depletion deductions, thus encouraging them to continue to operate marginal properties.

The current alternative minimum tax (AMT) also severely limits the incentive effects of IDC expensing, particularly for independent producers. Raising the net income limit and reducing the impact of the AMT on drilling incentives limit might also encourage added investment in exploratory drilling projects.

The level of exploratory drilling (and ultimately domestic reserves) would be increased by providing a program of temporary IDC credits, less restrictive rules for the use of percentage depletion, and AMT relief, all targeted to exploratory drilling in general, and to independent producers in particular. A temporary tax credit for new tertiary enhanced recovery projects would also encourage the recovery of known energy deposits that are currently too costly to produce.

#### Description of Proposal

Four incentives are proposed to encourage exploration for new oil and gas fields and the reclamation of old fields. Two proposals would provide tax credits which would be phased out if the average daily U.S. wellhead price of oil is at or above \$21 per barrel for an entire calendar year. Because future oil prices are expected to exceed this price at some point, these credits should be viewed as inherently temporary, rather than as permanent features of the tax system. The other two proposals would enhance the incentive effects of current energy tax law.

First, a temporary 10 percent tax credit would be allowed for the first \$10 million of expenditures (per year, per company) on exploratory intangible drilling costs and a 5 percent credit would be allowed for the balance of exploratory drilling costs. This proposal would be effective for costs incurred on or after January 1, 1991.

Second, a temporary 10 percent tax credit, effective January 1, 1991, will be allowed for all capital expenditures on new tertiary enhanced recovery projects (i.e., projects that represent the initial application of tertiary enhanced recovery to a property). These tax credits could be applied against both the regular tax and the alternative minimum tax. However, the credits, in conjunction with all other credits and net operating loss carryforwards, could not eliminate more than 80 percent of the tentative minimum tax in any year. Unused credits could be carried forward.

Third, the proposal would eliminate the "transfer rule," which discourages the transfer of proven properties to independent producers and royalty owners, and would increase the percentage depletion deduction limit for independent producers to 100 percent of the net income of each property. These changes would increase the availability to independent producers of the percentage depletion tax incentive. The effective date of each change would be January 1, 1991.



Fourth, the proposal would eliminate 80 percent of current AMT preference items generated by exploratory IDCs incurred by independent producers effective January 1, 1991. Thus, independent producers would be allowed to deduct 80 percent (rather than zero, as under current law) of exploratory excess IDCs in excess of the net income limit for purposes of the AMT. As under current law, the net income limit would be equal to 65 percent of oil and gas net income determined without regard to excess IDC deductions.

Effects of Proposal

The proposed new incentive program for the oil and gas industry would encourage exploration for new oil and gas fields and the reclamation of old fields. The incentives would strengthen the financial health of the smaller independent producers. They would help maintain a level of exploratory drilling activity which would provide continuing opportunities for skilled geologists and drilling contractors, many of whom have already left the industry. Although modest in scale, the program would help preserve the resource base and the human capital that may be needed in the future if the nation is to maintain a reasonable degree of energy independence.

Revenue Estimate

	Fiscal Years					
	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>
	(Billions of Dollars)					
Ten percent credit for exploratory drilling:	0	-0.2	-0.3	-0.3	-0.4	-0.4
Ten percent credit for tertiary enhanced recovery:	0	-*	-*	-*	-*	-*
Eliminate the transfer rule and increase the net income limit to 100 percent for percentage depletion:	0	-*	-*	-*	-*	-*
Eliminate 80 percent of exploratory IDC tax preferences from minimum tax for independent producers:	0	-0.1	-0.1	-0.1	-0.1	-0.1

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-\* Represents revenue loss of \$50 million or less.



## ENTERPRISE ZONE TAX INCENTIVES

### Current Law

Existing Federal tax incentives generally are not targeted to benefit specific geographic areas. Although the Federal tax law contains incentives that may encourage economic development in targeted economically distressed areas, the provisions generally are not limited to use with respect to such areas.

Among the existing general Federal tax incentives that aid economically distressed areas is the targeted jobs tax credit. This credit provides an incentive for employers to hire economically disadvantaged workers and often is available to firms located in economically distressed areas. An investment credit also is allowed for certain investment in low-income housing or the rehabilitation of certain structures that may be located in economically distressed areas. Another Federal tax incentive permits the deferral of capital gains taxation upon certain transfers of low-income housing and certain exchanges of business or investment property for property of the same kind. In addition, tax-exempt state and local government bonds may be used to finance certain activities conducted in economically distressed areas.

### Reason for Change

Despite sustained national prosperity and growth, certain areas have not kept pace. To help these economically distressed areas share in the benefits of continued economic growth, this Administration proposes to designate Federal enterprise zones in which targeted tax incentives and regulatory relief will stimulate government and private sector revitalization of the areas.

### Description of Proposal

The proposed enterprise zone initiative would include selected Federal income tax employment and investment incentives. These incentives will be offered in conjunction with Federal, state, and local regulatory relief. Up to 50 zones will be selected over a four-year period.

The incentives are: (i) a 5 percent refundable tax credit for qualified employees with respect to their first \$10,500 of wages earned in an enterprise zone (up to \$525 per worker, with the credit phasing out between \$20,000 and \$25,000 of total annual wages of the employee); (ii) elimination of capital gains taxes for tangible property used in an enterprise zone business and located within an enterprise zone for at least two years; and (iii) expensing by individuals of contributions to the capital of corporations engaged in the conduct of enterprise zone businesses (provided the corporation has less than \$5 million of total assets and uses the contributions to acquire tangible assets

located within an enterprise zone, and limiting the expensing to \$50,000 annually per investor with a \$250,000 lifetime limit per investor).

The willingness of states and localities to "match" Federal incentives will be considered in selecting the special enterprise zones to receive these additional Federal incentives.

Effects of the Proposals

Enterprise zones would encourage private industry investment and job creation in the economically distressed areas by removing regulatory and other barriers inhibiting growth. They would also promote growth through selected tax incentives to reduce the risks and costs of operating or expanding in severely depressed areas. A new era of public/private partnerships is needed to help distressed cities and rural areas help themselves.

Revenue Estimate

	Fiscal Year					
	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>
	(Billions of Dollars)					
Enterprise zone incentives:	0	-0.1	-0.2	-0.3	-0.5	-0.8

**NEW CHILD TAX CREDIT AND  
REFUNDABLE CHILD AND DEPENDENT CARE CREDIT**

Current Law

The Internal Revenue Code provides assistance to low-income working parents through both the earned income tax credit (EITC) and the child and dependent care credit.

Earned Income Tax Credit. Low-income workers with minor dependents may be eligible for a refundable income tax credit of up to 14 percent of the first \$6,810 in earned income. The maximum amount of the EITC is \$953. The credit is reduced by an amount equal to 10 percent of the excess of adjusted gross income (AGI) or earned income (whichever is greater) over \$10,730. The credit is not available to taxpayers with AGI over \$20,264. Both the maximum amount of earnings on which the credit may be taken and the income level at which the phase-out region begins are adjusted for inflation (1990 levels are shown).

Earned income eligible for the credit includes wages, salaries, tips and other employee compensation plus the amount of the taxpayer's net earnings from self-employment. Eligible individuals may receive the benefit of the credit in their paychecks throughout the year by electing advance payments.

Child and Dependent Care Credit. Working families may also be eligible for a nonrefundable income tax credit if they incur expenses for the care of a qualifying individual in order to work. A qualifying individual is (1) a dependent who is under the age of 13 for whom the taxpayer can claim a dependency exemption; (2) the spouse of the taxpayer if the spouse is physically or mentally incapable of caring for himself or herself; or (3) a dependent of the taxpayer who is physically or mentally incapable of caring for himself or herself.

To claim the child and dependent care credit, taxpayers must be married and filing a joint return or be a head of household. Two-parent households, with only one earner, do not qualify for the credit unless the nonworking spouse is disabled or a full-time student.

The amount of employment-related expenses that is eligible for the credit is subject to both a dollar limit and an earned income limit. Employment-related expenses are limited to \$2,400 for one qualifying individual and \$4,800 for two or more qualifying individuals. Further, employment-related expenses cannot exceed the earned income of the taxpayer, if single, or for married couples, the earned income of the spouse with the lower earnings.

Taxpayers with AGI of \$10,000 or less are allowed a credit equal to 30 percent of eligible employment-related expenses. For taxpayers with AGI of \$10,000 to \$28,000, the credit is reduced by one percentage point for each \$2,000, or fraction thereof, above \$10,000. The credit is limited to 20 percent of employment-related dependent care expenses for taxpayers with AGI above \$28,000.

### Reasons for Change

Current law does not adequately provide for the child care needs of low-income families. For low-income families which rely on paid child care arrangements, child care expenditures consume a large share of their income. On average, child care expenditures constitute 6 percent of income for all families which paid for the care of their preschool children. But, for low-income families with working mothers, child care expenditures constitute about 20 percent of income. Further, because the child and dependent care credit is not refundable, many low-income families can not claim the credit since they do not incur a federal income tax liability.

In addition, child care by relatives - much of which is not paid for in cash - is especially prevalent among low-income families. Over half of low-income families with preschool children do not make cash expenditures and could not benefit from the child and dependent care credit, even if it was refundable.

The EITC, while refundable, does not adjust for differences among working families in the costs of providing care according to the age of the dependent child or the number of dependent children. Preschool children generally require more extensive child care services than older children who may be in a school setting for much of the day.

### Description of Proposal

A new or modified child care credit may be claimed (in addition to the current law earned income credit) by low-income working families.

New Child Tax Credit. Low-income families, containing at least one worker, would be entitled to take a new tax credit of up to \$1,000 for each dependent child under age four. For each child under the age of four, families could receive a credit equal to 14 percent of earned income, with a maximum credit equal to \$1,000 per child. Initially, the credit would be reduced by an amount equal to 20 percent of the excess of AGI or earned income (whichever is greater) over \$8,000. As a consequence, the credit would not be available to families with AGI or earned income greater than \$13,000. In subsequent years, both the starting and end-points of the phase-out range would be increased by \$1,000 increments. In 1995, the credit would phase-out between \$15,000 and \$20,000. Beginning in 1996, the income thresholds would be indexed for inflation.

The credit would be refundable and would be effective for tax years beginning after December 31, 1990. Families would have the option of receiving the refund in advance through a payment added to their paycheck.

Refundable Child and Dependent Care Credit. The existing child and dependent care credit would be made refundable (but otherwise unchanged). Families could not claim both the new child credit and the child and dependent care credit with respect to the same child but could choose the larger of the two credits. The refundable child care credit would be effective for tax years beginning January 1, 1991.

### Effects of the Proposal

The proposal would increase the resources available to low-income families, better enabling them to choose the child care arrangements which best suit their needs and correspond to their personal values. The child care proposal, combined with newly legislated increases in the minimum wage, will lift a single mother of two preschool children, who works full-time at the minimum wage, above the poverty level.

About 2.2 million working families with children under the age of four will initially be eligible for the new child tax credit. When the proposal is fully implemented, eligibility will be expanded to approximately 1 million additional families. These families will also have the option of claiming the refundable child and dependent care credit, although they will not be able to claim both credits with respect to the same child. In addition, low-income parents of children between the ages of four and twelve would benefit from the refundability of the child and dependent care credit if they incur child-care expenses in order to work.

Consider, for example, a single mother of two children, ages three and six. The mother earns \$10,000 a year and has no other sources of taxable income. She pays a neighbor \$20 a week to care for her younger child. Her older child is enrolled in an after-school program during the winter months and a neighborhood park program during the summer at a total cost of \$500 per year. In total, she spends \$1,540 a year for child care in order to work. Under current law, she is not entitled to claim the child and dependent care credit. At a 30 percent credit rate on dependent care expenses, the credit would be \$462. However, she has no tax liability as a consequence of the standard deduction and personal exemptions and therefore cannot claim the credit.

Under the proposal, the mother will be able to claim the new child credit. In 1991, she will be entitled to a credit equal to \$600. (A mother in similar circumstances in 1993 would be entitled to the full \$1,000 credit.) In addition, the mother will be able to claim a refundable child and dependent care credit of \$150 on the basis of the expenses associated with the day-care of

her older child. In total, she will be entitled to an additional refund of \$750. Under both current law and the proposed changes, she will also receive an EITC of about \$990, bring her total 1991 refund under the proposal to \$1,740.

Revenue Estimate<sup>1</sup>

	Fiscal Years					
	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>
	(Billions of Dollars)					
New child care credit and refundable child and dependent care credit:	-0	-*	-*	-*	-0.1	-0.1

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\* Revenue loss of less than \$50 million.

<sup>1</sup> Increased outlays attributable to refunds payable to eligible individuals with no tax liability are estimated to be \$0.2 billion in 1991, \$1.8 billion in 1992, \$2.0 billion in 1993, \$2.1 billion in 1994, and \$2.2 billion in 1995.



## DEDUCTION FOR SPECIAL NEEDS ADOPTIONS

### Current Law

Expenses associated with the adoption of children are not deductible under current law. However, expenses associated with the adoption of special needs children are reimbursable under the Federal-State Adoption Assistance Program (Title IV-E of the Social Security Act). Special needs children are those who by virtue of special conditions such as age, physical or mental handicap, or combination of circumstances, are difficult to place for adoption. The Adoption Assistance Program includes several components. One of these components requires states to reimburse families for costs associated with the process of adopting special needs children. The Federal Government shares 50 percent of these costs up to a maximum Federal share of \$1,000 per child. Reimbursable expenses include those associated directly with the adoption process such as legal costs, social service review, and transportation costs. Some children are also eligible for continuing Federal-State assistance under Title IV-E of the Social Security Act. This assistance includes Medicaid. Other children may be eligible for continuing assistance under State-only programs.

### Reasons for Change

The Tax Reform Act of 1986 (the "1986 Act") repealed the deduction for adoption expenses associated with special needs children. Under prior law, a deduction of up to \$1,500 of expenses associated with the adoption of special needs children was allowed. The 1986 Act provided for a new outlay program under the existing Adoption Assistance Program to reimburse expenses associated with the adoption process of these children. The group of children covered under the outlay program is somewhat broader than the group covered by the prior deduction. The prior law deduction was available only for special needs children assisted under Federal welfare programs. Aid to Families with Dependent Children (AFDC), Title IV-E Foster Care, or Supplemental Security Income (SSI). The current adoption assistance outlay program provides assistance for adoption expenses for these special needs children, as well as special needs children in private and State-only programs.

Repeal of the special needs adoption deduction may have appeared to some as a lessening of the Federal concern for the adoption of special needs children.

An important purpose of the Adoption Assistance Program is to enable families in modest circumstances to adopt special needs children. In a number of cases the children are in foster care with the prospective adoptive parents. The prospective parents would like to formally adopt the child but find that to do so would impose a financial hardship on the entire family.

While the majority of eligible expenses are expected to be reimbursed under the continuing expenditure program, the Administration is concerned that in some cases the limits may be set below actual cost in high-cost areas or in special circumstances. Moreover, inclusion in the tax code of a deduction for special needs children may alert families who are hoping to adopt a child to the many forms of assistance provided to families adopting a child with special needs.

#### Description of Proposal

The proposal would permit the deduction from income of expenses incurred associated with the adoption of special needs children up to a maximum of \$3,000 per child. Eligible expenses would be limited to those directly associated with the adoption process that are eligible for reimbursement under the Adoption Assistance Program. These include court costs, legal expenses, social service review, and transportation costs. Only expenses for adopting children defined as eligible under the rules of the Adoption Assistance Program would be allowed. Expenses which were deducted and reimbursed would be included in income in the year in which the reimbursement occurred.

#### Effects of Proposal

The proposal when combined with the current outlay program would assure that reasonable expenses associated with the process of adopting a special needs child do not cause financial hardship for the adoptive parents. The proposed deduction would supplement the current Federal outlay program. In addition, the proposal highlights the Administration's concern that adoption of these children be specially encouraged and may call to the attention of families interested in adoption the various programs that help families adopting children with special needs.

There is currently uncertainty regarding whether Federal and State reimbursements are income to the adopting families. The proposal would clarify the treatment of reimbursements by making them includable in income but also deductible, up to \$3,000 of eligible expenses per child. Additionally, qualified expenses up to this limit would be deductible even though not reimbursed.

While the costs of adoption of a special needs child are only a small part of the total costs associated with adoption of these children, the Administration believes that it is important to remove this small one-time cost barrier that might leave any of these children without a permanent family.

Revenue Estimate

	Fiscal Years					
	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>
	(Billions of Dollars)					
Deduction for special needs adoption:	0	-*	-*	-*	-*	-*

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-\* Revenue loss of less than \$50 million.



## LOW-INCOME HOUSING TAX CREDIT

### Current Law

A tax credit is allowed for certain expenditures with respect to low-income residential rental housing. The low-income housing credit generally may be claimed by owners of qualified low-income buildings in equal annual installments over a 10-year credit period as long as the buildings continue to provide low-income housing over a 15-year compliance period.

In general, the discounted present value of the installments may be as much as 70 percent of eligible expenditures. Eligible expenditures include the depreciable costs of new construction and substantial rehabilitations, as well as the cost of acquiring certain existing buildings not placed in service within the previous ten years and not subject to the 15-year compliance period. The basis of property is not reduced by the amount of the credit for purposes of depreciation and capital gain.

The annual credit available for a building cannot exceed the amount allocated to the building by the designated State or local housing agency. As originally enacted, the total allocations by the housing agency in a given year could not exceed the product of \$1.25 and the State's population. A State credit allocation is not required, however, for certain projects financed with tax-exempt bonds subject to the State's private activity bond volume limitation. While the credits originally could not be allocated after 1989, the Omnibus Budget Reconciliation Act (OBRA) of 1989 extended each State's credit allocation authority through 1990 at a level equal to the product of \$0.9375 and the State's population.

### Reason for Change

The low-income housing credit encourages the private sector to construct and rehabilitate the nation's rental housing stock and to make it available to the working poor and other low-income families. In addition to tenant-based housing vouchers and certificates, the credit would appear to be an important mechanism for providing Federal assistance to rental households. Because the effectiveness of this newly designed incentive was unclear when introduced in the Tax Reform Act of 1986, it was felt appropriate to limit its availability. While extended by OBRA through 1990 (at a reduced limit), it is useful to allow a more extensive examination of this method of providing low income housing assistance.

### Description of Proposal

The proposal would extend the credit through 1991, and would establish each State's credit allocation authority for 1990 and 1991 at a level equal to the product of \$1.25 and the State's population.

Effects of the Proposal

The proposal would allow continued utilization of the low-income housing credit through 1991. This would not only provide additional needed low-income housing, but allow a greater period of application over which the efficiency of the program may be tested.

Revenue Estimate

	Fiscal Years					
	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>
	(Billions of Dollars)					
Extend and expand low-income housing tax credit:	-*	-0.1	-0.3	-0.4	-0.4	-0.4

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-\* Revenue loss of less than \$50 million.

**EXTEND SPECIAL RULES FOR  
HEALTH INSURANCE COSTS OF SELF-EMPLOYED INDIVIDUALS**

Current Law

Current law allows a self-employed individual to deduct as a business expense up to 25 percent of the amount paid during a taxable year for health insurance coverage for himself, his spouse, and his dependents. Originally, this deduction was only available if the insurance was provided under a plan that satisfied the non-discrimination requirements of section 89 of the Code. Section 89 has since been repealed retroactively, however, and no non-discrimination requirements currently apply to such insurance. The value of any coverage provided for such individuals and their families by the business is not deductible for self-employment tax purposes. The deduction is scheduled to expire after September 30, 1990. For taxable years beginning in 1990, the deduction is allowed only for premiums paid for coverage through October 1, 1990.

Reasons for Change

The 25 percent deduction for health insurance costs of self-employed individuals was added by the Tax Reform Act of 1986 because of a disparity between the tax treatment of owners of incorporated and unincorporated businesses (e.g., partnerships and sole proprietorships). Under prior law, incorporated businesses could generally deduct, as an employee compensation expense, the full cost of any health insurance coverage provided for their employees (including owners serving as employees) and their employees' spouses and dependents. By contrast, self-employed individuals operating through an unincorporated business could only deduct the cost of health insurance coverage for themselves and their spouses and dependents to the extent that it, together with other allowable medical expenses, exceeded 5 percent of their adjusted gross income. (Coverage provided to employees of the self-employed, however, was and remains a deductible business expense for the self-employed.) The special 25 percent deduction was designed to mitigate this disparity in treatment.

Description of Proposal

The proposal would make the 25 percent deduction permanent.

Effects of Proposal

The proposal will continue to reduce the disparity in tax treatment between self-employed individuals and owners of incorporated businesses, compared to prior law.

Revenue Estimate

	Fiscal Year					
	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>
	(Billions of Dollars)					
Extend special rules for health insurance costs of self-employed individuals:	-*	-0.2	-0.4	-0.5	-0.5	-0.6

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-\* Revenue loss of less than \$50 million.



**EXTEND SOCIAL SECURITY RETIREMENT COVERAGE TO  
STATE AND LOCAL EMPLOYEES  
NOT PARTICIPATING IN PUBLIC EMPLOYEE RETIREMENT PROGRAMS**

Current Law

State and local government employees are not required to participate in the retirement (Old Age, Survivors, and Disability Insurance) portion of Social Security. If these employers and employees do not voluntarily join the system, wages are not subject to the social security retirement tax (6.2 percent on both employers and employees).

Reasons for Change

Currently about 4 million state and local employees, many of whom are part-time workers and students, are not covered by OASDI or public retirement plans. Extending coverage would provide retirement income protection to those who do not currently have access to Social Security benefits.

Description of Proposal

Effective October 1, 1990, mandatory social security coverage would be extended to those employees of state and local governments who do not participate in a retirement system in conjunction with their current employment.

Effects of Proposal

An additional 4 million state and local government employees, and their employing governments, would contribute to Social Security. All state and local government employees would be eligible for OASDI or other retirement benefits.

Revenue Estimate<sup>1</sup>

	Fiscal Years					
	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>
	(Billions of Dollars)					
Extend social security retirement coverage to State and local employees:	0	2.1	2.2	2.3	2.5	2.7

<sup>1</sup> Net of income tax offset.



## MEDICARE HOSPITAL INSURANCE (HI) FOR STATE AND LOCAL EMPLOYEES

### Current Law

State and local government employees hired on or after April 1, 1986, are covered by Medicare Hospital Insurance and their wages are subject to the Medicare tax (1.45 percent on both employers and employees). Employees hired prior to April 1, 1986, are not covered by Medicare Hospital Insurance nor are they subject to the tax.

### Reasons for Change

State and local government employees are the only major group of employees not assured Medicare coverage. A quarter of state and local government employees are not covered by voluntary agreements or by law. Extending coverage would provide access to Medicare to those who would otherwise not be eligible to receive Medicare benefits, and would eliminate the inequity and the drain on the Medicare trust fund caused by those who receive Medicare without fully contributing.

### Description of Proposal

As of October 1, 1990, all state and local government employees would be covered by Medicare Hospital Insurance.

### Effects of Proposal

An additional 2 million state and local government employees would be contributing to Medicare. Of these, roughly 300,000 employees would become newly eligible to receive Medicare benefits subject to satisfying the minimum 40 quarters of covered employment.

### Revenue Estimate<sup>1</sup>

	Fiscal Years					
	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>
	(Billions of Dollars)					
Extend Medicare hospital insurance coverage to State and local employees:	0	1.7	1.7	1.7	1.7	1.6

<sup>1</sup> Net of income tax offset



## AIRPORT AND AIRWAY TRUST FUND

### Current Law

The Airport and Airway Trust Fund supports the capital and operating programs of the Federal Aviation Administration (FAA). The Trust Fund receives revenue from taxes imposed on users of the nation's air transportation system. These taxes include the 8 percent air passenger tax, the 5 percent air freight tax, the 12 cents per gallon noncommercial aviation gasoline tax, and the 14 cents per gallon noncommercial aviation jet fuel tax. In addition, the Trust Fund receives revenue from the international air departure tax, which was increased from \$3 to \$6 by the Omnibus Budget Reconciliation Act of 1989. The Airport and Airway Trust Fund taxes are scheduled to expire after 1990.

The Omnibus Budget Reconciliation Act of 1989 suspended for one year a trigger that would reduce several of the Airport and Airway Trust Fund taxes. The trigger would also take effect after 1990 if the appropriations in fiscal years 1989 and 1990 for capital programs funded by these taxes are less than 85 percent of authorizations. The trigger would reduce by 50 percent both the air passenger tax and the air freight tax, and it would substantially reduce the aviation gasoline tax.

Under Gramm-Rudman-Hollings, the current services budget includes the extension of excise tax trust fund receipts and outlays at the levels in effect during the budget year. As a consequence, the 1991 budget baseline includes the extension of the Airport and Airway Trust Fund tax rates at their current levels irrespective of the trigger. The actual realization of Airport and Airway Trust Fund tax receipts at current services levels would require an extension of the taxes at their current rates (which implies a repeal of the trigger).

### Reason for Change

The Airport and Airway Development and Revenue Act of 1970 established the Airport and Airway Trust Fund as a mechanism for financing the capital and operating programs of the FAA through taxes imposed on the users of the nation's air transportation system. The Airport and Airway Trust Fund taxes have never covered total FAA outlays and, in fact, are projected to cover only 60 percent of total FAA outlays in 1990.

### Description of Proposal

The proposal would raise the air passenger tax to 10 percent, the air freight tax to 6.25 percent, the noncommercial aviation gasoline tax to 15 cents per gallon, and jet the noncommercial fuel tax to 17.5 cents per gallon. However, the proposal would not affect the international air departure tax.

Effects of Proposal

The proposal would increase by 25 percent the baseline levels of several of the Airport and Airway Trust Fund taxes after 1990.

Revenue Estimate<sup>1</sup>

	Fiscal Years					
	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>
	(Billions of Dollars)					
Airport and airway trust fund:	0	0.5	0.8	0.9	0.9	1.0

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<sup>1</sup> Net of income tax offsets.

## EXTENSION OF THE COMMUNICATIONS (TELEPHONE) EXCISE TAX

### Current Law

The Omnibus Budget Reconciliation Act of 1987 extended the communications excise tax until December 31, 1990. The tax is imposed at a rate of three percent on local and toll telephone service and on teletypewriter exchange service.

### Reasons for Change

The communications excise tax was originally enacted in 1914 and has been imposed continuously since 1932, even though it has been scheduled to expire continuously since 1959. Allowing the tax to expire will reduce Federal tax receipts by approximately \$2.5 billion annually at 1992 levels.

### Description of Proposal

The proposal would permanently extend the three percent communications excise tax. The tax rate is substantially less than the ten percent rate that was in effect between 1954 and 1972, and as low or lower than the rate in effect for any year since 1932 (except for 1980-82). The base of the tax would not be broadened.

### Effects of Proposal

Extension of the communications excise tax would maintain a revenue source that has been in existence since 1932, and would avoid the disruption that would occur if the tax were allowed to expire and then were re-enacted.

### Revenue Estimate<sup>1</sup>

	Fiscal Years					
	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>
	(Billions of Dollars)					
Extend telephone excise tax:	0	1.5	2.5	2.7	2.9	3.1

<sup>1</sup> Net of income tax offset.





## TREATMENT OF SALVAGE VALUE BY PROPERTY AND CASUALTY INSURANCE COMPANIES

### Present Law

In calculating underwriting income under current law, property and casualty insurance companies may deduct underwriting losses (and expenses) in the year in which they are incurred (section 832). The deduction for losses incurred consists of a deduction for losses paid during the taxable year, and a deduction for the increase in (discounted) reserves for losses incurred during the taxable year but still unpaid as of the end of the taxable year.

The deduction for losses paid during the taxable year must be reduced to take account of salvage and reinsurance. Insurance companies, however, are not required to reduce paid losses by salvage attributable to such losses if any state, territory, or the District of Columbia prohibits the company from treating the salvage as an asset for statutory purposes. The deduction for unpaid losses must be discounted as provided in section 846. The deduction for losses and expenses incurred, both paid and unpaid, is required to be "reasonable."

### Reasons for Change

Several states have rules prohibiting the reporting of any salvage (including subrogation claims) not reduced to cash or cash equivalents. These rules reflect the generally conservative nature of state reporting measures, which are designed primarily to ensure the solvency of insurance companies. The exclusion of such a significant portion of salvage, while consistent with state regulatory ends, does not result in an accurate measurement of income for federal tax purposes. The state regulatory rules allow companies to determine losses incurred on a gross basis rather than on a net basis (i.e. gross losses incurred minus salvage value). As a result, the deduction for paid losses is overstated by the amount of salvage expected to be received in the future. (The salvage value is later taken as income when received.) This overstatement of deductions results in a mismatching of underwriting income and underwriting expenses. A more accurate measure of income for federal tax purposes can be achieved by requiring the matching of expected salvage recovery value against paid losses.

A more accurate measurement of income accrued can also be achieved through adjusting reserves for unpaid losses by estimated recoveries of salvage, and reinsurance value. In addition, making this adjustment is consistent with the current regulations that require the deduction for losses incurred to be a fair and reasonable estimate of the liability.

Description of Proposal

Section 832 would be amended to require that the deduction for losses incurred, both paid and unpaid, be reduced by estimated recoveries of salvage (including subrogation claims) attributable to such losses, whether or not the salvage is treated as an asset for statutory purposes. Treasury would be given regulatory authority to provide for the discounting of any salvage to be taken into account.

The provision would apply to taxable years beginning after December 31, 1989. Application of this provision is a change in the taxpayer's method of accounting for purposes of section 481. Taxpayers must spread the section 481 adjustment over a period not exceeding four years, in accordance with the rules applicable to a change in method of accounting initiated by the taxpayer and approved by the Internal Revenue Service. In all cases, the amount of the adjustment required by section 481 will be the difference between the amount of unreduced loss reserves at the end of the taxable year immediately preceding the first taxable year beginning after December 31, 1989, and the amount of the reduced loss reserve determined under this proposal as of the beginning of the first taxable year beginning after December 31, 1989.

Effects of Proposal

The proposal will ensure that the salvage and subrogation value received by insurance companies cannot be used to defer income from taxation by overstating the deductions taken for underwriting losses (and expenses). The total deductions taken for any given policy loss will remain unchanged; however, the timing of those deductions will more accurately reflect income accrued. The tax benefit received by insurance companies through the mismeasurement of their taxable incomes under current law will be recovered by the proposal.

Revenue Effect

The proposal is estimated to increase budget receipts as follows:

	Fiscal Year					
	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>
	(Billions of dollars)					
Treatment of salvage value by insurance companies:	0.2	0.2	0.2	0.2	0.1	0.1

## PAYROLL TAX DEPOSIT STABILIZATION

### Current Law

Under current law, employers deposit income taxes and FICA (social security) taxes withheld from employees' wages together with the employers' matching shares of FICA taxes. The frequency of payment is related to the amount of unpaid liability.

Smaller employers pay accumulated payroll tax liabilities of \$500 or more after the end of the month; payroll tax liabilities under \$500 are paid after the end of each calendar quarter.

Until August, 1990, larger employers are required to deposit payroll taxes as frequently as eight times a month. Employers who have \$3,000 or more of accumulated but undeposited payroll taxes at the end of eighth-monthly periods (periods which end on the 3rd, 7th, 11th, 15th, 19th, 22nd, 25th, and last days of each month) are required to deposit at least 95 percent of such taxes within three banking days. The remainder is due with the first deposit otherwise required after the 15th of the following month.

Beginning in August, 1990, under provisions of the Omnibus Reconciliation Act of 1989 (OBRA), payment of accumulated liabilities of \$100,000 or more will be accelerated and deposits may be required more frequently than eight times a month. An employer who is on the eighth-monthly deposit system will be required to deposit at least 95 percent of accumulated payroll taxes by the close of the next banking day after any day on which the employer has undeposited payroll taxes accumulated within that eighth-monthly period of \$100,000 or more, regardless of whether that day is the last day of an eighth-monthly period.

From August, 1990 through December, 1990, accumulated, unpaid payroll taxes of \$100,000 or more trigger a next banking day deposit requirement. During 1991, such amounts must be deposited by the second banking day. During 1992 and ~~1993~~, such amounts must be deposited by the third banking day. During ~~1994 and 1995~~ <sup>1994 and 1995</sup>, such amounts must again be deposited by the next banking day. After 1995, OBRA empowers the Treasury Department to issue regulations to set the deposit dates in a similar manner in order to minimize the unevenness of the receipts effects of the provision. It is anticipated that deposits would continue to be required on the next banking day.

### Reasons for Change

Most payroll taxes are withheld from the wages and salaries of employees and are held by employers as agents for the U.S. Government. The delay between the payroll date and the date on which the withheld taxes are paid to the Treasury was originally intended to permit employers to verify the amount of payroll tax liability and to minimize the administrative burdens and processing costs of immediate payment for employers and the government.

In recent years, the advances in automated payroll and accounting equipment have virtually eliminated the need for any delay between the payroll date and the date on which the taxes are deposited by the employer. In recognition of this, Congress in the Omnibus Budget Reconciliation Act of 1989 required many employers to make deposits on the next banking day after they have accumulated undeposited payroll taxes of \$100,000 or more. This change is effective for amounts required to be deposited after July 31, 1989.

However, this change was not made permanent. Instead the one-day delay applies only in 1990, and then automatically shifts to two days in 1991, to three days in 1992, and then back to one day in 1993 and 1994. After 1994, the Secretary of the Treasury is directed to issue regulations which "minimize the unevenness" in the revenue effect of the provision.

The automatic shift from one to two days in 1991, and from two to three days in 1992, is inconsistent with the rationale which Congress gave for the change which it made in 1989 -- that is, that advances in payroll systems make such delays unnecessary. Moreover, current law would place substantial burdens on employers who would be forced to reprogram their payroll system for four years in a row to take account of the shifting deposit dates.

#### Description of Proposal

Under the proposal, an employer who is on the eighth-monthly deposit system would be required to deposit at least 95 percent of accumulated payroll taxes by the close of the next banking day after any day on which the employer had undeposited payroll taxes accumulated within that eighth-monthly period of \$100,000 or more, regardless of whether that day is the last day of an eighth-monthly period. The proposal would become effective for payroll tax deposits beginning in August, 1990.

#### Effects of Proposal

The proposal would change the OBRA-mandated second banking day deposit requirement for 1991 and the third banking day deposit requirement for 1992 and 1993 to a next day deposit requirement. Under the proposal, the change to next banking day deposits imposed by OBRA and scheduled to become effective in August, 1990 would be permanent and would be the only change required by employers.

The proposal to continue next banking day payroll tax deposits after 1990 would not impose any new burdens on affected employers. In fact, since much of the burden of payroll tax deposit requirements is from adjusting to changes, the current proposal will ease administrative burdens by eliminating the currently scheduled changes in deposit rules in 1991, 1992, and 1994.

Revenue Estimate

Fiscal Years

1990    1991    1992    1993    1994    1995

(Billions of Dollars)

Stabilize payroll tax  
deposits:

0      0.9      2.2      -3.1      0      0



**PERMIT LIMITED USE OF EXCESS PENSION FUNDS  
TO PAY RETIREE HEALTH BENEFITS**

Current Law

Pension plan assets may not revert to an employer prior to termination of the plan and the satisfaction of all plan liabilities. Any assets that revert to the employer upon such termination are included in the gross income of the employer and are subject to a 15 percent excise tax.

A pension plan may provide medical benefits to retirees through a section 401(h) account that is part of such plan. The assets of a pension plan may not be transferred to a section 401(h) account without disqualifying the pension plan and subjecting the amounts transferred to income and excise taxes.

Reasons for Change

Many employers currently have substantially over-funded pension plans. At the same time, many of these employers are facing significant retiree health liabilities for which current law permits limited tax-favored pre-funding. The proposal would permit employers to use some portion of excess pension plan assets to satisfy current retiree health liabilities under the same plan.

Description of Proposal

The transfer of excess pension plan assets to a 401(h) account to pay current retiree health benefits would be allowed without termination or disqualification of the plan. The amount of the transfer could not exceed the amount of assets in excess of 140 percent of the plan's current liability or, if less, the plan's current retiree health liabilities for the current year. Amounts transferred would not be includable in gross income or subject to the excise tax on reversions.

Transfers would be permitted on an interim basis only, thereby enabling policy makers to evaluate the effectiveness and the long-term revenue effects of this approach to satisfy retiree health liabilities. In the event of a transfer, the pension plan would be subject to additional requirements with respect to pension benefits, such as full vesting, to preserve benefit security. More specifically, only one transfer would be permitted. The transfer would have to occur before January 1, 1993 and in a plan year beginning after December 31, 1990.

Effects of Proposal

Employers could be expected to transfer funds from the pension portion of an over-funded plan rather than making additional contributions to a 401(h) account under the same plan. Since additional contributions are deductible from income, taxable income would be increased in the short run. In the longer run, however, the reduction in assets available to pay pension benefits could result in a corresponding increase in contributions for that purpose.

Revenue Estimate

	Fiscal Year					
	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>
	(Billions of Dollars)					
Permit limited use of excess pension funds to pay retiree health benefits:	0	0.2	0.4	0.2	0.0	0.0



## INITIATE IRS MANAGEMENT REFORMS

### Current Management Procedure:

The IRS currently allocates substantial resources to direct enforcement of the tax laws. Direct enforcement encompasses activities designed to encourage accurate reporting of taxable income and to assess or collect taxes, penalties, and interest which are owed but not reported or paid. In allocating resources to these activities, the IRS does not simply seek to collect the maximum amount of taxes; rather, the objective is to encourage and enhance voluntary compliance (i.e., indirect revenue effects are also considered). Consequently, a portion of its resources are routinely allocated to direct enforcement activities which have historically resulted in relatively low yields (i.e., revenues to costs).

### Reasons for Changes:

The IRS has identified a number of current opportunities in the enforcement area in which a temporary reallocation of resources already at hand would be particularly useful.

### Description of Proposal:

These management reforms would change the allocation of specific resources, and results from a special effort to identify specific areas of opportunity. A description of these actions follows, along with the estimated FY 1991 impact on revenue:

- o Examination FY 1991 Tax Shelter Initiative--Resources would be reallocated to accelerate the examination process for tax shelter cases with attendant expedited closure of such cases. Significant key cases will be prioritized and targeted for expeditious handling. The overall impact involves a two-year window of opportunity, and the FY 1991 estimated revenue will be \$349.0 million.
- o CEP Settlement Authority--Examinations in the Coordinated Examination Program enter the administrative appeals process on unagreed issues at the close of the examination. This initiative would delegate appeals settlement authority to the CEP examiners on the basis of historical appeals settlement precedents. The result would be an acceleration of the receipt of taxes, penalties, and interest, and the FY 1991 effect is estimated to be \$546.7 million.
- o Excise Tax Initiative--An additional 150 staff years of existing revenue agent staffing is to be redirected from lower yielding areas to examination of excise tax returns. The FY 1991 revenue effect is estimated to be \$2.3 million.

- o Employee Plans/Exempt Organizations--This initiative focuses on the actuarial examinations of small retirement plans. Resources will be shifted from other examination and determination activities to this program, increasing the number of examinations in this area from the previously planned 700 to 18,000. The revenue effect starts in FY 1990, with additional collections of \$64.0 million, and \$602 million in FY 1991.
- o Counsel/Appeals--This initiative will shift 145 staff years from Examination staff to Appeals staff to help close targeted large cases in the appeals process. There are 47 targeted cases which are expected to be closed in FY 1991, yielding collections of \$1.0 billion in that year.

Effects of Proposal:

All affected activities are in the area of direct enforcement. Consequently, the proposal should enhance the amount of revenue directly resulting from specific cases, while also expediting the collection of past due taxes.

Revenue Estimates

	Fiscal Years					
	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>
	(Billions of Dollars)					
Initiate IRS management initiatives:	0.1	2.5	1.1	0.5	-*	-0.4

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-\* Revenue loss of less than \$50 million.

## INCREASE IN IRS FY 1991 ENFORCEMENT FUNDING

### Current Law

The IRS currently allocates substantial resources to direct enforcement of the tax laws. Direct enforcement encompasses activities designed to encourage accurate reporting of taxable income and to assess or collect taxes, penalties, and interest which are owed but not paid. In allocating resources to these activities, the IRS does not simply seek to collect the maximum amount of taxes; rather, the objective is to encourage and enhance voluntary compliance (i.e., indirect revenue effects are considered).

### Reasons for Changes

The IRS has identified a number of enforcement areas in which specific problems exist that could be resolved by the application of additional resources. In addition, the gap between taxes owed and taxes voluntarily paid contributes to the Federal deficit and undermines the system of voluntary compliance.

### Description of Proposal

Increases IRS funding for tax law enforcement, and for the collection of delinquent taxes, penalties, and interest. The specific programs, new budget authority and estimated FY 1991 receipts are as follows:

- o Examination District Office Initiative--An additional 1,049 staff years (and 127 support staff years) are to be applied to excise tax and estate and gift tax audits. Total budget authority for FY 1991 is \$77.1 million, and the effect on collections in that year is a reduction of \$18.2 million, due to initial opportunity costs.
- o Examination Service Center--This initiative will expand Service Center Examination programs by applying an additional 640 staff years, with an FY 1991 budget authority of \$27.3 million, to a variety of correspondence audits: Schedule A deductions, dependents, duplicated expenses, and deductions in excess of statutory limits. Collections in FY 1991 are estimated to increase by \$143.6 million.
- o Examination Contract Training--Current training programs utilize experienced revenue agents as instructors. This initiative will reduce the opportunity costs of training by substituting contract instructors for a substantial portion of recruit classroom training. The FY 1991 budget authority is \$7.5 million, and the estimated revenue impact for that year is \$13.8 million.

- o Examination Claims Auditing--This initiative would apply 100 revenue agent staff years (and 46 support staff years), with a budget authority of \$7.9 million in FY 1991, to increase examinations of claims for refunds of taxes. There is no estimated revenue impact for FY 1991.
- o Collection of Accounts Receivable--This initiative will apply an additional 987 revenue officer staff years (and an additional 66 staff years for support), with total FY 1991 budget authority of \$55.5 million, to the accounts receivable inventory. In FY 1991, increased collections of past due taxes, penalties and interest will amount to \$150.2 million.
- o Returns Processing, Document Matching--This initiative would expand matching of noncustodial agreements by applying the equivalent of 366 staff years, with budget authority of \$12.3 million, to this activity. The estimated increase in collections for FY 1991 is \$172.6 million.
- o Returns Processing, Dependent SSN Matching--This initiative will expand matching of dependent social security numbers by application of the equivalent of 84 staff years, with a budget authority of \$2.9 million. The estimated increase in collections for FY 1991 is \$57.5 million.
- o Returns Processing, Mortgage Interest Credit--This initiative will expand matching of the mortgage interest credit by application of the equivalent of 14 additional staff years, with an FY 1991 budget authority of \$0.5 million. Increase collections in FY 1991 are estimated to be \$17.5 million.

Effects of Proposal:

All affected activities are in the area of direct enforcement. Consequently, the proposal should enhance the level of revenue collection, encourage taxpayers to correctly report their income for tax purposes, and expedite the collection of past due taxes.

Revenue Estimates

	Fiscal Years					
	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>
	(Billions of Dollars)					
Increase IRS enforcement funding:	0	0.5	0.8	1.3	1.5	1.6

## MISCELLANEOUS PROPOSALS AFFECTING RECEIPTS

### Description of Proposals

Increase the District of Columbia (D.C.) employer contribution to the civil service retirement system (CSRS). Effective January 1, 1991, the D.C. government would be required to phase-in payments for current CSRS employee cost of living (COLAs) liabilities, as well as to pay the cost of COLAs for post-1986 CSRS annuitants.

Increase ad valorem fee on shippers. The current ad valorem fee on shippers would be increased from .04 percent of cargo value to approximately 0.125 percent of cargo value. This increase would fully offset the cost of Corps of Engineers harbor maintenance dredging; currently 40% of the cost of the program is recovered by the fee. It would also offset the cost of certain National Oceanic and Atmospheric Administration marine programs, including coastal mapping, marine weather, and circulation and tide data.

Increase and expand Securities Exchange Commission (SEC) fees. Effective July 1, 1990, the fee on securities market transactions would be increased from 1/300 to 1/220 of 1 percent of dollar volume traded, and would be extended to apply to most over-the-counter securities transactions. In addition, the fee charged for merger or proxy filing would be increased from 1/50 to 1/40 of 1 percent of the value of the transaction. Similarly, the registration fee on securities offerings would be increased from 1/50 to 1/40 of 1 percent of the value of the offering.

Modify collection period of telephone excise tax. Under present law the telephone tax billed to a customer in a given semimonthly period is considered to be collected during the second following semimonthly period. The tax is deposited within three banking days after the semimonthly period in which it is considered to be collected. Under this proposal the tax would be collected during the first week of the second following semimonthly period and would be deposited within three banking days after the end of that week. This change would be effective for taxes considered collected for semimonthly periods beginning after December 31, 1990.

Extend abandoned mine reclamation fees. The abandoned mine reclamation fees, which are scheduled to expire in August 1992, would be extended. Collections from the existing fees of 35 cents per ton for surface mined coal and 15 cents per ton for under ground mined coal are allocated to States for reclamation grants. Extensive abandoned land problems are expected to exist after all the money from the collection of existing fees is expended.

Establish Commodity Futures Trading commission (CFTC) fees. Effective October 1, 1990, a futures market transactions fee of 11 cents per transaction would be established to cover the cost of CFTC expenses.

Change collection point of special taxes in connection with liquor occupations. To increase compliance rates and revenues, the special occupation taxes currently levied on retailers would be eliminated and the existing taxes on wholesalers and manufacturers would be increased effective October 1, 1990.

Extend social security and Medicare hospital insurance (OASDHI) coverage to D.C. employees. This proposal would extend OASDHI coverage to all newly hired D.C. employees effective January 1, 1991. Most D.C. employees are currently covered.

Extend IRS user fees. The existing fee on each request for a letter ruling, determination letter, opinion, or other similar ruling or determination filed after January 31, 1988 and before October 1, 1990 would be permanently extended.

Establish Federal Emergency Management Agency (FEMA) user fees. Beginning October 1, 1990, 100 percent of FEMAs costs incurred as the Nuclear Regulatory Commission's agent in regulating the evacuation plans of nuclear power plants would be recovered through user fees.

Extend and expand railroad unemployment insurance (UI) reimbursable status. To prevent public subsidies from being diverted to pay for the high unemployment cost of the private sector railroads, public commuter railroads were exempt from the full railroad unemployment tax rate in 1989 and will continue to be exempt in 1990. Instead, they are required to reimburse the unemployment insurance fund for the actual costs of their employees. Under this proposal the exemption provided to public commuter railroads would be extended beyond its current law expiration date and would be expanded to Amtrak beginning in 1991.

Modify Federal Reserve reimbursement. A permanent, indefinite appropriation to reimburse Federal Reserve banks for their services as fiscal agents for the Bureau of Public Debt will be established. This would result in a corresponding increase in the deposit of earnings by the Federal Reserve System, which are classified as receipts.

Delay for 3 months the Federal employee pay raise. The Federal employee pay raise is proposed to be delayed 3 months from October 31, 1990 to January 1, 1991.

Establish Corps of Engineers application fees for permits. Revised regulations are being developed that would enable the Corps of Engineers to begin collecting fees on requests for permits necessary for development or other activities in navigable waterways and wetlands. These fees would be effective October 1, 1990.

Other. Additional proposals include an increase in the HUD interstate land sales fee and modification of the EPA pesticide fee.

Revenue Estimate

	Fiscal Year					
	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>
	(Billions of Dollars)					
Increase D.C. contributions to CSRS	0	*	*	*	0.1	0.1
Increase ad valorem fees on shippers	0	0.3	0.3	0.3	0.4	0.4
Increase and expand SEC fees	*	0.1	0.1	0.1	0.1	0.1
Modify collection period of telephone excise tax	0	0.1	*	*	*	*
Extend abandoned mine reclamation fees	0	0	0.1	0.3	0.3	0.3
Establish CFTC fee	0	*	*	*	0.1	0.1
Change collection point for liquor occupation taxes	0	*	*	*	*	*
Extend OASDHI coverage to DC employees	0	*	*	*	*	*
Extend IRS user fee	0	0.1	0.1	0.1	0.1	0.1
Establish FEMA fees	*	*	*	*	*	*
Extend and expand railroad UI reimbursable status	0	-*	-*	0	-*	-*
Modify Federal Reserve reimbursement	0	0.1	0.1	0.1	0.1	0.1
Delay Federal pay raise	0	-*	-0.1	-0.1	-0.1	-0.1
Establish Corps of Engineers fees	0	*	*	*	*	*
Other	0	-0.1	-0.2	-*	-*	-*

\* Revenue gain of less than \$50 million.

-\* Revenue loss of less than \$50 million.

