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of the
Administration's Revenue Proposals



Department of the Treasury
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Summary of the Administration's Revenue Proposals

The Department of the Treasury released its "Summary of the Administration's Revenue Proposals" on February 28, 1993. The Summary describes the revenue proposals included in the Administration's comprehensive economic plan. The proposals are part of a program designed to achieve three goals: providing a short-term economic stimulus for job creation; building an environment for long-term investment and growth; and reducing the structural budget deficit. The descriptions are not intended to be final or comprehensive - many will be revised in the process of finalizing the Administration's fiscal year 1994 Budget and numerous details will be provided in connection with the presentation of the Budget and upon submission of legislation to implement the Administration's plan.

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ADMINISTRATION REVENUE PROPOSALS

This report summarizes the revenue proposals included in the Administration's comprehensive economic plan. The proposals are part of a program designed to achieve three goals: providing a short-term economic stimulus for job creation; building an environment for long-term investment and growth; and reducing the structural budget deficit. The investment and stimulus revenue proposals are targeted to achieve the maximum impact for the minimum revenue cost. The revenue raising proposals restore progressivity to the income tax system, ensure that both domestic and international businesses bear their fair share of the tax burden, and encourage energy conservation and independence.

The descriptions included in this report are not intended to be final. Many of the proposals will be revised in the process of finalizing the Administration's fiscal year 1994 Budget. The descriptions are also not intended to be comprehensive. Numerous details, such as rules relating to the prevention of abusive transactions and the limitation of tax benefits inconsistent with the principles of the proposals, will be provided in connection with the presentation of the Budget and upon submission of legislation to implement the Administration's plan.

In addition to the proposals summarized in this report, the Administration also supports initiatives designed to promote sensible and equitable administration of the internal revenue laws. These include simplification, good governance and technical correction proposals.

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TREASURY DEPARTMENT

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STIMULUS/INVESTMENT PROVISIONS

TRAINING AND EDUCATION

EXTEND EXCLUSION FOR EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE

Current Law

Under current law, the value of employer-provided educational assistance is included in an employee's income and employment tax wages unless the cost of the assistance would qualify as a deductible, job-related expense of the employee if the employee had incurred the expense directly. Under prior law, amounts paid by an employer with respect to an employee under an educational assistance program were excluded from the employee's gross income and employment tax wages to the extent that the value of the assistance did not exceed \$5,250 per year, regardless of whether the expense would otherwise be deductible. Such programs were subject to nondiscrimination rules to ensure that the assistance was not provided primarily to higher-paid employees. The educational assistance exclusion is not applicable to taxable years beginning after June 30, 1992.

Reasons for Change

The exclusion encourages employers to provide educational assistance and thereby increases the country's productivity. In addition, absence of the exclusion imposes significant administrative burdens on employers, workers, and the IRS in distinguishing between job-related expenses (which are excludable from gross income under current law when paid by the employer) and other employer-provided educational expenses. Absent the exclusion, the value of employer-provided educational assistance is excludable from gross income only if the education directly relates to the employee's current job and does not qualify the employee for a different trade or business. Higher-income, higher-skilled individuals may more easily satisfy these requirements because of the breadth of their prior training and current job responsibilities.

Proposal

The proposal would permanently extend the general exclusion for employer-provided educational assistance. The provision is effective for taxable years ending after June 30, 1992.

EXTEND AND EXPAND TARGETED JOBS TAX CREDIT TO INCLUDE YOUTH APPRENTICES

Current Law

The targeted jobs tax credit is available to employers on an elective basis for hiring individuals from nine targeted groups. The targeted groups are: (1) vocational rehabilitation referrals; (2) economically disadvantaged youths aged 18 through 22; (3) economically disadvantaged Vietnam-era veterans; (4) Supplemental Security Income (SSI) recipients; (5) general assistance recipients; (6) economically disadvantaged cooperative education students aged 16 through 19; (7) economically disadvantaged ex-convicts; (8) eligible work incentive employees; and (9) economically disadvantaged summer youth employees aged 16 or 17. Certification of targeted group membership is required as a condition of claiming the credit.

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

The credit is not available for wages paid to a targeted group member unless the individual either (1) is employed by the employer for at least 90 days (14 days in the case of economically disadvantaged summer youth employees), or (2) has completed at least 120 hours of work performed for the employer (20 hours in the case of economically disadvantaged summer youth employees). The employer's deduction for wages must be reduced by the amount of the credit claimed. The credit expired June 30, 1992.

Reasons for Change

The targeted jobs tax credit is intended to encourage employers to hire workers who otherwise may be unable to find employment and to subsidize training costs. Job creation incentives are required in the current economic climate. In addition, a significant number of youth in the United States lack the necessary skills to meet requirements for entry level positions and, therefore, are unprepared to make the transition from school to the workforce.

Proposal

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

apprentices beginning work after December 31, 1993.

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

Because the youth apprenticeship program is a work-study program, the credit would equal 40 percent of up to \$3,000 of first-year wages, for a maximum credit of \$1,200.

CAPITAL INVESTMENT AND ECONOMIC GROWTH

INVESTMENT TAX CREDIT

Current Law

The "regular" investment tax credit was repealed by the Tax Reform Act of 1986. Therefore, there is no such credit under current law.

Prior to the 1986 Act, the regular investment credit was a credit against tax liability for up to 10 percent of a taxpayer's investment in new "section 38 property." Section 38 property generally included any tangible personal property and other tangible property (not including a building or its structural components) used as an integral part of manufacturing, production, or extraction, or for furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services. The credit also was available for up to \$125,000 of the taxpayer's cost of used property placed in service during a taxable year.

The amount of the credit was based on the ACRS recovery period to which the property was assigned. The 10 percent credit was allowed for 5-year property, 10-year property, and 15-year public utility property. For 3-year property the credit was limited to 6 percent.

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

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

Reasons for Change

Increasing investment in new plant and equipment is necessary to stimulate the economy in the short-run and create new jobs. Additional investment would also augment the capacity of the economy to produce goods and services more efficiently, and thereby improve the standard of living in the long-run. At the same time, in view of current budgetary constraints, any investment stimulus must be designed to provide the

maximum incentive to increase productive investments at the least possible cost in terms of foregone revenues. Finally, investment incentives should, to the extent practicable, be administrable for all taxpayers, with particular attention given to limiting compliance burdens on small business.

Proposal

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

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

Small Business Investment Tax Credit

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

A small business would generally be defined as a business with average annual gross receipts of less than \$5 million in the three years immediately preceding the taxable year, using principles similar to those provided for determining whether corporations may use the cash method of accounting under section 448. The small business investment tax credit would generally be similar to the regular investment credit prior to the 1986 Act. Recapture rules would apply to early dispositions of property. The taxpayer's depreciable basis would be reduced by the amount of the credit.

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

Incremental Investment Tax Credit

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

The fixed base would equal a percentage of a taxpayer's average historic investment in new and used property in 1989 through 1991, or, if the taxpayer elects, with respect to investments in 1987 through 1991. The amount of historic investment would be indexed for growth in the gross domestic product, and multiplied by 70 percent to determine the fixed base through December 31, 1993, and multiplied by 80 percent to determine the fixed base for 1994. Taxpayers would not be permitted to claim the credit on more than 50 percent of qualified investment in a taxable year. Thus, a firm with a fixed base of \$1 million and qualifying investment of \$6 million would only be permitted to claim the credit with respect to \$3 million of investment.

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

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

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

Effects of Proposal

The proposal would reduce the cost of capital and increase funds available for investment. These additional expenditures on plant and equipment would create more jobs in capital goods industries and other manufacturing industries.

The temporary incremental investment tax credit would promote purchases of new equipment, and thereby promote capital investment, modernization, and a more rapid economic recovery in the short run. The incremental investment tax credit would provide a cost-effective investment incentive by reducing the windfall to investors on investments they would have undertaken even without the credit. Because the credit would be available only for eligible plant and equipment placed in service on or before December 31, 1994, the revenue cost of the credit is reduced and the investment stimulus is maximized during 1993 and 1994.

The permanent credit for small businesses would promote increased investments by small businesses. The credit should reduce the marginal cost of capital of small firms. In addition, the credit for small businesses would be administratively less burdensome for small firms than an incremental credit.

EXTEND RESEARCH & EXPERIMENTATION CREDIT

Current Law

Taxpayers are entitled to a tax credit for incremental "qualified research expenditures" paid or incurred on or before June 30, 1992. The credit equals 20 percent of the amount by which the taxpayer's qualified research expenditures for the taxable year exceed a base amount. The base amount is the product of the taxpayer's "fixed base percentage" and the average of the taxpayer's gross receipts for the four preceding years. The fixed base percentage is the ratio of the taxpayer's qualified research expenditures to its gross receipts during the 1984-1988 period. The base amount, however, cannot be less than 50 percent of the taxpayer's current-year qualified research expenditures.

Qualified research expenditures consist of (1) "in house" expenses of the taxpayer for research wages and supplies used in research, (2) certain time-sharing costs for computer use in research, and (3) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf. Certain types of research are specifically excluded from qualified research, such as research conducted outside the United States, research in the social sciences, arts, or humanities, and research funded by another person or governmental entity.

A special rule determines the fixed base percentage of start-up companies. This rule assigns a fixed base percentage of 3 percent to any taxpayer that did not have both gross receipts and qualified research in at least three years during the 1984-1988 period.

The 20 percent tax credit also applies to amounts paid or incurred by a corporation on or before June 30, 1992, for basic research by universities or other qualified organizations, to the extent that those amounts exceed the greater of two prescribed floor amounts plus an amount reflecting decreases in the corporation's non-research donations to universities.

Reasons for Change

Increasing investment in research activities is important to foster economic growth and technological development and improve international competitiveness. Many of the benefits of research, however, cannot be captured by the business making the investment. Instead, these benefits redound to competitors and to the public. Therefore, in the absence of an incentive for research, businesses might not invest in research at the levels that are appropriate for the economy as a whole. To foster economic growth and technological development and improve international competitiveness, the research credit should be permanently extended.

Proposal

The proposal would permanently extend the research tax credit. The provision would apply to expenditures paid or incurred after June 30, 1992.

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

PROVIDE TARGETED CAPITAL GAINS EXCLUSION

Current Law

Under current law, long-term capital gains are generally taxable at an individual investor's marginal income tax rate, subject to a maximum statutory rate of 28 percent. While the Tax Reform Act of 1986 eliminated the capital gains exclusion of prior law, it did not eliminate the legal distinction between capital gains and ordinary income, or between short-term and long-term capital gains. These distinctions currently serve to identify those transactions that are eligible for the 28 percent maximum rate and that are subject to the limitations on deducting capital losses. Long-term capital gains on shares of stock generally qualify for the 28 percent maximum rate.

Reasons for Change

Small businesses are important to economic growth and job creation in this country, and contribute to America's edge in international competition. A sustained flow of capital to new businesses that may generate minimal short-term earnings, but promise strong future profitability, would improve our future competitiveness. A preferential tax rate for long-term commitments of capital to small businesses would encourage investments in innovation and growth. The resulting increase in national output would benefit all Americans by providing jobs and raising living standards.

Proposal

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

Individuals would be allowed to exclude 50 percent of capital gains realized upon the disposition of qualified small business stock held over 5 years, and would apply their current statutory rate on capital gains (either 15 or 28 percent) to the reduced amount of taxable gain. Gain eligible for the exclusion would be limited to the greater of ten times

the investor's basis in the stock or \$1 million for each qualified small business. One half of any exclusion claimed would be treated as a tax preference item under the individual alternative minimum tax.

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

MODIFY AMT DEPRECIATION SCHEDULE

Current Law

Under current law, taxpayers are subject to an alternative minimum tax (AMT) which is payable to the extent that the taxpayer's tentative minimum tax exceeds its regular income tax liability. The tentative minimum tax generally equals 20 percent of a corporation's alternative minimum taxable income (24 percent in the case of an individual). Alternative minimum taxable income is the taxpayer's taxable income increased by its tax preferences and adjusted by redetermining its tax treatment of certain items.

One of the adjustments made to taxable income to arrive at alternative minimum taxable income is a depreciation adjustment. In computing alternative minimum taxable income, depreciation on personal property to which the Modified Accelerated Cost Recovery System (MACRS) applies is generally calculated using the 150 percent declining-balance method over the class life of the property. By comparison, a 200 percent declining-balance method over recovery periods shorter than class lives is generally permitted under MACRS in arriving at taxable income. If a taxpayer elects, or is required, to depreciate personal property pursuant to a straight-line depreciation method in computing taxable income, this method (and the recovery periods used in computing taxable income) must also be used to compute alternative minimum taxable income.

Another adjustment in arriving at a corporation's alternative minimum taxable income is based on adjusted current earnings (ACE). In general, the ACE adjustment increases taxable income by an amount equal to 75 percent of the excess of ACE over alternative minimum taxable income (determined without regard to the ACE adjustment). In computing ACE, depreciation is generally computed using the straight-line method over the class life of the property.

To the extent that a taxpayer's regular income tax liability exceeds its tentative minimum tax in a particular taxable year, the taxpayer is entitled to reduce its regular income tax liability by a credit (the minimum tax credit) which is based on AMT paid in preceding years. The minimum tax credit is generally intended to permit the reversal of the effects of the AMT when the treatment of items in arriving at taxable income becomes less favorable than the treatment permitted in arriving at alternative minimum taxable income.

Reasons for Change

There is general concern that the AMT treatment of depreciation causes a disincentive to capital investment. As a result of depreciation adjustments, many capital-

capital-intensive businesses are subject to the AMT. The effects of the adjustments are magnified for capital-intensive businesses that are growing or showing depressed earnings. Because many businesses may find themselves continually subject to the AMT, the minimum tax credit is of reduced value in mitigating the long-term effects of the AMT depreciation adjustments.

The AMT treatment of depreciation is also the source of substantial complexity. Corporations must make three separate depreciation computations to determine taxable income and alternative minimum taxable income. All taxpayers must compute depreciation over one period for regular tax and another for AMT.

Proposal

Effective for property placed in service after December 31, 1993, the depreciation component of the adjustment used in computing ACE would be eliminated, and AMT depreciation would be computed using the 120 percent declining-balance depreciation method over the recovery periods applicable for regular tax purposes. This amendment would not apply to property eligible only for the straight-line method for regular tax purposes (e.g., residential and nonresidential real property).

Effects of Proposal

The proposal would (1) provide relief from the AMT for capital intensive businesses, (2) simplify the AMT for corporations by requiring only one computation of depreciation for AMT purposes, and (3) generally allow taxpayers to use a single recovery period for computing tax depreciation.

INCENTIVES FOR HIGH-SPEED RAIL

Current Law

States and local governments are permitted to issue tax-exempt private activity bonds to finance certain exempt facilities, including airports, docks and wharves, mass commuting facilities, sewage facilities, and high speed rail facilities. With the exception of bonds for airports, docks and wharves, and governmentally owned solid waste disposal facilities, tax-exempt private activity bonds are generally subject to State private activity bond volume limitations. In the case of private activity bonds for high-speed rail facilities, only 25 percent of the bonds are subject to the State private activity bond volume limitations.

Reasons for Change

As a result of the capital intensive nature of high-speed rail facilities, the cost of these facilities is very large, resulting in the need to issue a significant amount of bonds to finance such facilities. The State private activity bond volume limitations are a significant barrier to the issuance of tax-exempt bonds to finance these facilities.

Proposal

The proposal would exempt private activity bonds to provide high-speed rail facilities from the State private activity bond volume limitations. The provision is effective for bonds issued after December 31, 1993.

EXTEND SMALL-ISSUE MANUFACTURING AND AGRICULTURAL BONDS

Current Law

Interest on small issues of private activity bonds issued by States and political subdivisions thereof ("qualified small issue bonds") is excluded from gross income if certain conditions are met. First, at least 95 percent of the bond proceeds must be used to finance manufacturing facilities or certain agricultural land or equipment. Second, the bond issue must be issued in an aggregate amount of \$1 million or less, or the aggregate amount of the issue, together with the aggregate amount of certain related capital expenditures, may not exceed \$10 million. A number of other restrictions apply to these bonds.

The volume of qualified small issue bonds that may be issued is limited by the annual State private activity bond volume limit.

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

Reasons for Change

Qualified small issue bonds provide assistance for small businesses and certain farmers. It is appropriate to permit State and local governments to continue to issue qualified small issue bonds, subject to the State private activity bond volume limit.

Proposal

The proposal permanently extends the authority to issue qualified small issue bonds. The provision is effective for bonds issued after June 30, 1992.

ENTERPRISE ZONES

ESTABLISH ENTERPRISE ZONES

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 development in economically distressed areas, the availability of the incentives is not conditioned on activity in or development of the areas.

Reasons for Change

A combination of government and private efforts is needed to assist distressed cities and rural areas in sharing the benefits of economic growth.

Proposal

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

EXPAND EARNED INCOME TAX CREDIT

EXPANSION AND SIMPLIFICATION OF EARNED INCOME TAX CREDIT

Current Law

The earned income tax credit (EITC) is a refundable credit consisting of (i) a basic credit (adjusted for family size), (ii) a supplemental credit for workers with a child under the age of one, and (iii) a supplemental credit for certain health insurance premium expenses. In 1993, the basic EITC rate is 18.5 percent of the first \$7,750 of earned income for a worker with one child (providing a maximum credit of \$1,434) and 19.5 percent for a worker with two or more children (a maximum credit of \$1,511). The young child credit and health insurance credit increase the basic EITC rate by 5 and 6 percentage points, respectively (thereby increasing the maximum credit amount by \$388 and \$465, respectively).

The basic EITC is reduced by an amount equal to 13.21 percent of the excess of adjusted gross income (or, if greater, earned income) over \$12,200. The phaseout rate for a family with two or more children is 13.93 percent. Beginning at the same income threshold, the young child credit and health insurance credit increase the phaseout rate by 3.57 and 4.285 percentage points, respectively. The credits are not available to taxpayers with incomes of \$23,050 or more. Each year, the income thresholds for both the phasein and phaseout ranges are adjusted for changes in the cost-of-living.

In 1994 and thereafter, the basic EITC rate will increase to 23 percent for a worker with one child and 25 percent for a worker with two or more children. The corresponding phaseout rates will be 16.43 percent and 17.86 percent, respectively.

Reasons for Change

The federal government assists low-income workers in a number of ways, such as through the enforcement of a minimum wage and the food stamp program. Yet, the income (including the EITC and food stamps) of a family of four with only one full-time, minimum-wage worker falls below the official poverty threshold.

Proposal

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

INVESTMENT IN REAL ESTATE

EXTEND MORTGAGE REVENUE BONDS

Current Law

Qualified mortgage bonds (QMBs) are bonds the proceeds of which are used to finance the purchase, or qualifying rehabilitation or improvement, of single-family, owner-occupied residences. Persons receiving QMB-financed loans generally must satisfy principal residence, purchase price, income, first-time homebuyer, and other requirements.

The volume of QMBs that may be issued is limited by the annual State private activity bond volume limit.

Governmental units may exchange annual private activity bond volume limit for the authority to issue mortgage credit certificates (MCCs). MCCs entitle homebuyers to nonrefundable income tax credits for a specified percentage of the interest paid on mortgage loans on their principal residences. MCCs are subject to the same eligibility and other requirements as QMBs. Once issued, an MCC remains in effect as long as the mortgage loan remains outstanding and the residence financed continues to be used as the MCC-recipient's principal residence.

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

Reasons for Change

The QMB and MCC programs enable lower and middle-income individuals and families who otherwise would be unable to afford homes to do so.

Proposal

The proposal permanently extends the authority to issue QMBs and to elect to trade in private activity bond volume limit for authority to issue MCCs. The extension of the QMB and MCC programs is effective after June 30, 1992.

EXTEND LOW-INCOME HOUSING CREDIT

Current Law

A tax credit is allowed in annual installments over 10 years for newly constructed or substantially rehabilitated low-income rental housing. For most newly constructed and substantially rehabilitated housing, the credit percentages provide a credit stream with a present value equal to 70 percent of the total qualified expenditures. In the case of housing receiving other federal subsidies, and in the case of the acquisition of an existing building that is substantially rehabilitated, the credit percentages provide a credit stream with a present value equal to 30 percent of the total qualified expenditures. Generally, that part of the building for which the credit is claimed must be rented to qualified low-income tenants at restricted rents for 15 years after the building is placed in service.

Generally, in order for a credit to be claimed with respect to a building, the building owner must receive a credit allocation from the appropriate credit authority. The low-income housing credit is allocated by State or local government authorities subject to an annual limitation for each State. The population component of the annual State credit limitation was \$1.25 per resident for 1992, but this portion of the State credit limitation could not be allocated after June 30, 1992.

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

Reasons 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 is an important mechanism for providing federal assistance to families that rent housing.

Proposal

The proposal would make permanent the low-income housing tax credit. The provision is effective after June 30, 1992.

PROVIDE PASSIVE LOSS RELIEF FOR CERTAIN REAL ESTATE ACTIVITIES

Current Law

The passive loss limitation rules provide generally that if a taxpayer's losses from passive activities exceed his income from passive activities for a taxable year, the excess losses are disallowed and carried forward to the next taxable year. The purpose of the passive loss rules is to discourage tax-motivated investments in tax shelters that, prior to the Tax Reform Act of 1986, permitted taxpayers to offset their active business and other income by incurring tax losses on investments in which they took no active part.

To determine whether a taxpayer has passive losses for a taxable year under current law, the taxpayer's operations must be organized into activities that are either trade or business activities or rental activities. In general, rental operations may not be treated as part of a trade or business activity. Thus, for example, an integrated real estate business that involves the development, management, and rental of real property would ordinarily be treated as two activities (one trade or business and one rental) rather than one.

A trade or business activity is passive unless the taxpayer materially participates in the activity. Treasury regulations provide that, in general, the material participation standard is satisfied if a taxpayer participates for more than 500 hours in the activity for the taxable year. Rental activities, however, are passive, regardless of the level of the taxpayer's participation. Thus, in general, losses from rental activities may offset only rental income or other passive income. A limited exception to this treatment of rental activities permits a taxpayer to treat up to \$25,000 of real estate rental losses as nonpassive. This exception applies only to losses from activities in which the taxpayer actively participates (a lesser standard of involvement than material participation) and is phased out for upper-income taxpayers.

The passive loss limitation rules apply to individuals, estates, trusts, and personal service corporations. Closely-held corporations may offset passive losses against active income, but may not offset passive losses against portfolio income, such as interest and dividends.

Reasons for Change

A taxpayer whose principal business involves real estate (including rental real estate) is disadvantaged under current law. Even if the taxpayer materially participates in all aspects of the business (including rentals), losses arising from the rental of real property may not be used to offset income from other aspects of the taxpayer's real estate business, except to the extent of the \$25,000 allowance described above. Thus, real estate professionals are treated less favorably than other business professionals who

are allowed to deduct losses from activities in which they materially participate.

Proposal

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

A taxpayer would meet the eligibility requirements for the special rule if more than half of the personal services the taxpayer performs in a trade or business during the taxable year are in real property trades or businesses in which he materially participates. For purposes of the eligibility requirements, personal services performed as an employee would not be treated as performed in a real property trade or business unless the person performing the services has more than a 5-percent ownership interest in the employer. In addition, the special rule would not apply to closely held C corporations.

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

Effects of Proposal

The proposal would ameliorate the disadvantageous treatment of real estate professionals under current law. This may encourage owners to hold troubled properties and make needed renovations, and make it easier for lenders, including the Resolution Trust Corporation, to dispose of troubled properties. The limited relief provided by the proposal will not undermine the important purpose of the passive loss rules, (*i.e.*, curbing tax shelters).

INCREASE RECOVERY PERIOD FOR DEPRECIATION OF NONRESIDENTIAL REAL PROPERTY

Current Law

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

Reasons for Change

The recovery period for nonresidential real property under current law results in depreciation allowances that are larger than the actual decline in value of the property. In order to measure more accurately the economic income derived from the use of nonresidential real property in a trade or business or an investment activity, the recovery period for the depreciation of such property should be increased.

Proposal

For regular tax purposes, nonresidential real property would be depreciated using the straight-line method and a recovery period of 36 years. The proposal generally would apply to property placed in service on or after February 25, 1993. The proposal would not apply to property that a taxpayer places in service before January 1, 1994, if (1) the taxpayer or a qualified person entered into a binding written contract to purchase or construct the property before February 25, 1993, or (2) construction of the property was commenced by or for the taxpayer or a qualified person before February 25, 1993. A qualified person for this purpose is any person who transfers rights in such a contract or such property to the taxpayer without first placing the property in service.

FACILITATE REAL ESTATE INVESTMENTS BY PENSION FUNDS AND OTHERS

1. Relax Restrictions on Debt-financed Real Estate Investments by Pension Funds and Others.

Current Law

Tax-exempt organizations are generally subject to the unrelated business income tax (UBIT) on income earned from debt-financed investments. Certain investments in real property by "qualified organizations" are excepted.

To qualify for the exception to the debt-financed income rules: (1) the purchase price must be fixed in amount; (2) the indebtedness must not be revenue dependent; (3) the real property must not be leased to the seller; (4) in the case of a qualified trust, the real property must not be acquired from, or leased to, a person related to any plan with respect to which the trust was formed; and (5) no seller financing may be provided. Additional requirements apply if the investment vehicle is a partnership.

Reasons for Change

The current rules impede legitimate leveraged acquisitions of real estate. One major aspect of the problem is that many qualified organizations consider it inappropriate to make any investment that generates unrelated business taxable income (UBTI), even if the amount of potential UBIT is economically insignificant.

Proposal

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

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

Relax Fixed Sales Price and Participating Loan Restrictions for Real Property Acquired from Financial Institutions. The fixed price and participating loan restrictions would not apply if: (1) a qualified organization acquires the real property from a financial institution (which would include some subsidiaries, and conservators or receivers); (2) the selling financial institution acquired the real property by foreclosure or

default, or held the real property at the time it entered conservatorship or receivership; (3) gain recognized by the seller of the real property is ordinary income; (4) the seller financing does not exceed the amount of the outstanding indebtedness (including accrued interest) on the real property at the time of the foreclosure or default; and (5) the maximum amount that may be paid pursuant to any participation features does not exceed 30 percent of the total purchase price (i.e., the fixed component and the contingent component) for the real property.

2. Repeal Rule Regarding Publicly Traded Partnerships.

Current Law

All tax-exempt organizations are subject to UBIT on their distributive share of income from publicly traded partnerships, regardless of whether the investment is debt-financed or whether the income is derived from an unrelated trade or business.

Reasons for Change

There is no compelling reason to subject all investments in a publicly traded partnership to UBIT since a direct investment (or an investment through a non-publicly traded partnership) in the same activity would in many instances not be subject to UBIT.

Proposal

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

3. Permit title-holding companies to receive some UBTI.

Current law

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

Reasons for Change

The tax-exempt status of title-holding companies is unnecessarily precarious because they often receive small amounts of UBTI (such as parking or vending machine revenues) that relate to real property to which they hold title.

Proposal

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

4. **Exclude From UBTI Gains and Losses from the Disposition of Certain Real Property Acquired from Financial Institutions in Conservatorship or Receivership.**

Current Law

Gain or loss from the sale, exchange or other disposition of property generally is excluded from UBTI. However, gain or loss from property held primarily for sale in the ordinary course of a trade or business is not excluded from UBTI.

Reasons for Change

Financial institutions in conservatorship or receivership routinely package parcels of real property to facilitate the sale of their real estate inventory. Purchasers typically "cull" unwanted properties, and retain only properties consistent with their long-term strategic needs. Exempt organizations often do not purchase packaged properties because they fear culled properties might be treated as sold to customers in the ordinary course of a trade or business and thereby subject the organization to UBIT.

Proposal

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

5. **Exclude from UBTI Loan Commitment Fees and Certain Option Premiums.**

Current Law

Gains on the lapse of options on securities are exempted from UBTI. Loan commitment fees and premiums from unexercised options on real estate may be subject to UBTI.

Reasons for Change

Subjecting loan commitment fees and option premiums on real estate to UBIT is inconsistent with the taxation of the underlying transactions, and impedes legitimate

transactions.

Proposal

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

6. **Effective Date**

The proposals generally would be effective January 1, 1994.

OTHER

REPEAL AMT PREFERENCE FOR GIFTS OF APPRECIATED PROPERTY TO CHARITIES

Current Law

In calculating taxable income for regular income tax purposes, a taxpayer is generally allowed to deduct the fair market value of property contributed to charitable organizations. For purposes of the alternative minimum tax (AMT), however, a taxpayer may not deduct the full value of long-term capital gain property contributed after June 30, 1992. Instead, the taxpayer must treat as a tax preference, and thus add back to alternative minimum taxable income (AMTI), the amount by which the fair market value of the property exceeds the taxpayer's basis in the property. Therefore, for AMT purposes, the taxpayer's deduction is effectively limited to the basis of the contributed property.

Reasons for Change

Eliminating the tax preference for contributions of appreciated property would encourage contributions of such property to universities, museums, and other charitable institutions.

Proposal

The proposal would eliminate the tax preference for contributions of appreciated property. The deduction allowable for a contribution of appreciated property would be the same for both regular tax and AMT purposes (and also for adjusted current earnings purposes, in the case of a C corporation), and generally would equal the full fair market value of the contributed property. The provision would apply to contributions of tangible personal property made after June 30, 1992, and contributions of other property made after 1992.

EXTEND GENERAL FUND TRANSFER TO RAILROAD RETIREMENT TIER II TRUST FUND

Current Law

The Railroad Retirement Solvency Act of 1983 changed the tax treatment of Tier II benefits under the Railroad Retirement system to parallel that of private pensions. It also provided for the transfer of income taxes resulting from the change (not to exceed \$877 million) on benefits received before October 1, 1988, from the General Fund of the Treasury to the Railroad Retirement Account. The \$877 million limit was repealed and the 1988 deadline was delayed to 1992 by the Omnibus Budget Reconciliation Act (OBRA) of 1987, OBRA 1989, and OBRA 1990.

Reasons for Change

The condition of the Railroad Retirement Account has deteriorated in recent years due to declining employment in the railroad industry. Currently, there are three retirees for every active employee in the railroad industry. Assuming that the current employment trends persist, the trust fund is estimated to be insolvent by 2016.

Proposal

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

EXTEND HEALTH INSURANCE DEDUCTION FOR SELF-EMPLOYED

Current Law

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

For coverage prior to July 1, 1992, a self-employed individual was allowed to deduct as a business expense up to 25 percent of the amount paid for health insurance coverage for himself, his spouse, and his dependents. Only amounts paid prior to July 1, 1992 are eligible for deduction. The deduction was not allowed if the self-employed individual or his or her spouse was eligible for employer-paid health benefits. Originally, this deduction was only available if the insurance was provided under a plan that satisfied the non-discrimination requirements of section 89. Section 89 was repealed before it became effective, however, after which no non-discrimination requirements applied to such insurance. The amount paid for health insurance coverage for self-employed individuals and their families was not deductible for self-employment tax purposes.

Reasons for Change

Current law creates a disparity between the tax treatment of owners of incorporated and unincorporated businesses (e.g., partnerships and sole proprietorships). An extension of the 25 percent deduction through the end of 1993 would retain current tax treatment for affected individuals until the Administration's comprehensive health care proposals have been formulated.

Proposal

Extend the 25 percent deduction through December 31, 1993. The provision is effective for taxable years ending after June 30, 1992.

REVENUE RAISING PROVISIONS

PROVISIONS THAT IMPROVE FAIRNESS OF THE TAX SYSTEM

INCREASE TAX RATES PAID BY HIGH-INCOME INDIVIDUALS

Current Law

Regular Tax Rates. The highest marginal tax rate imposed on the income of individuals, estates and trusts is 31 percent. For 1993, this rate applies to taxable income in excess of the following thresholds:

<u>Filing Status</u>	<u>Applicable Threshold</u>
Married individuals filing joint returns	\$89,150
Heads of households	\$76,400
Unmarried individuals	\$53,500
Married individuals filing separate returns	\$44,575
Estates and trusts	\$11,250

Rates of 15 and 28 percent apply to income ranges below these thresholds. For example, for estates and trusts, the 15 percent rate applies to income up to \$3,750, and the 28 percent rate applies to income between \$3,750 and \$11,250.

For years after 1993, the threshold amounts will be indexed for inflation.

The 31 percent marginal tax rate does not apply to capital gains, which are taxed at a maximum rate of 28 percent.

Alternative Minimum Tax Rate. Taxpayers are required to pay an alternative minimum tax (AMT) to the extent that tax exceeds their regular tax liability. For taxpayers other than corporations, AMT liability generally equals 24 percent of the amount by which the taxpayer's alternative minimum taxable income (AMTI) exceeds a prescribed exemption amount. The exemption amount is \$40,000 for married individuals filing joint returns, \$30,000 for unmarried individuals, and \$20,000 for married individuals filing separate returns, estates, and trusts. The exemption is reduced by 25 percent of the excess of AMTI over threshold amounts that vary by filing status: \$150,000 for married taxpayers filing joint returns; \$112,500 for heads of household or unmarried individuals; and \$75,000 for married taxpayers filing separate returns, estates and trusts.

A taxpayer's AMTI is computed by adding certain tax preference items, and making other specified adjustments, to the taxpayer's taxable income. The AMT thus limits the extent to which taxpayers can use various tax preferences to reduce their tax liability, and insures that taxpayers with substantial economic income pay at least a minimum amount of tax.

Itemized Deduction Limitation. Individuals who do not elect the standard deduction may claim itemized deductions (subject to certain limitations) for certain expenses. Among these deductible expenses are unreimbursed medical expenses, casualty and theft losses, charitable contributions, qualified residence interest, investment interest and other investment expenses, State and local income and property taxes, unreimbursed employee business expenses, certain moving expenses, and gambling losses (to the extent that they do not exceed winnings).

Taxpayers with AGI in excess of a prescribed threshold are required to reduce their otherwise allowable itemized deductions. The required reduction equals 3 percent of the amount by which the taxpayer's AGI exceeds the prescribed threshold. For 1993, the prescribed threshold is \$108,450. The threshold for subsequent years will be indexed for inflation. Otherwise allowable deductions, however, cannot be reduced by more than 80 percent. Further, the reduction does not apply to medical expenses, casualty and theft losses, investment interest, and gambling losses.

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

Phaseout of Personal Exemptions. In determining taxable income, an individual taxpayer is entitled to a deduction for each allowable personal exemption. A separate exemption is allowed for the taxpayer, the taxpayer's spouse, and each dependent of the taxpayer. For 1993, the deduction allowable for each exemption is \$2,350. For subsequent years, this amount will be indexed for inflation.

Taxpayers whose AGI exceeds a prescribed threshold must reduce or eliminate the deduction for personal exemptions to which they would otherwise be entitled. For 1993, the thresholds are \$162,700 for married individuals filing joint returns, \$135,600 for heads of households, \$108,450 for unmarried individuals, and \$81,350 for married individuals filing separate returns. For subsequent years, these threshold amounts will be indexed for inflation.

A taxpayer generally must reduce the deduction for exemptions by 2 percent of the otherwise allowable amount for each \$2,500 increment (or portion thereof) by which the taxpayer's AGI exceeds the applicable threshold. For married taxpayers filing separate returns, however, the applicable increment is \$1,250 instead of \$2,500.

The phaseout of personal exemption deductions does not apply to taxable years

beginning after December 31, 1996.

Reasons for Change

The proposal would increase the fairness of the tax system by ensuring that upper income taxpayers pay their fair share of federal income taxes. The proposal would provide a higher marginal tax rate for upper income taxpayers, who have the greatest ability to pay taxes.

Proposal

New Marginal Tax Rates. The proposal would provide a new 36 percent marginal tax rate that would apply to taxable income in excess of the following thresholds:

<u>Filing Status</u>	<u>Applicable Threshold</u>
Married individuals filing joint returns	\$140,000
Heads of households	\$127,500
Unmarried individuals	\$115,000
Married individuals filing separate returns	\$ 70,000
Estates and trusts	\$ 5,500

For estates and trusts, the 15 percent rate would apply to income up to \$1,500, the 28 percent rate would apply to income between \$1,501 and \$3,500, and the 31 percent rate would apply to income between \$3,501 and \$5,500. Under this modified tax rate schedule for estates and trusts, the benefits of the rates below the 39.6 percent surtax rate (described below) for 1993 would approximate the benefits of the 15 and 28 percent rates for 1993 under current law.

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

Alternative Minimum Tax Rate and Exemption Amounts. The proposal would provide a two-tiered progressive rate schedule for the AMT. This rate schedule would apply to taxpayers other than corporations. A 26 percent rate would apply to the first \$175,000 of a taxpayer's AMTI, and a 28 percent rate would apply to AMTI in excess of

\$175,000. For married individuals filing separate returns, the 28 percent rate would apply to AMTI in excess of \$87,500. The proposal would increase the exemption amounts to \$45,000 for married individuals filing joint returns, \$33,750 for unmarried individuals, and \$22,500 for married individuals filing separate returns, estates and trusts.

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

Itemized Deduction Limitation and Phaseout of Personal Exemptions. The proposal would make permanent the provisions that limit itemized deductions and phase out personal exemptions.

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

REPEAL HEALTH INSURANCE WAGE BASE CAP

Current Law

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

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

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

Reasons for Change

HI taxes fund Medicare. Unlike OASDI benefits, Medicare benefits are not limited by a taxpayer's lifetime earnings that have been subject to FICA taxes. Elimination of all restrictions on earnings subject to HI taxes would therefore make the calculation of Medicare contributions consistent with the calculation of Medicare benefits.

Proposal

The proposal would eliminate the dollar limit on wages and self-employment income subject to HI taxes for wages and income received after December 31, 1993.

Effect of Proposal

The proposal would enhance the solvency of the HI trust fund. Approximately 1.2 million high-wage workers would be affected by the increase.

REINSTATE TOP ESTATE AND GIFT TAX RATES AT 53 PERCENT AND 55 PERCENT

Current Law

The federal estate and gift taxes are unified so that a single progressive rate schedule is applied to an individual's cumulative gifts and bequests. The generation-skipping transfer tax is computed by reference to the maximum federal estate and gift tax rate.

In 1992, the federal estate and gift tax rates began at 18 percent on the first \$10,000 of taxable transfers and reached 55 percent on taxable transfers in excess of \$3 million. For transfers occurring after 1992, the maximum federal estate and gift tax rates was reduced to 50 percent on taxable transfers over \$2.5 million. The benefit of the graduated rates and the unified credit is phased out at a 5 percent rate for taxable transfers that exceed \$10,000,000 and do not exceed \$18,340,000.

Reasons for Change

Due to the need for all taxpayers to contribute to the current deficit situation, the Administration believes that a permanent extension of the top rates in effect in 1992 should be implemented, effective January 1, 1993.

Proposal

The top estate and gift tax rate would be reinstated, effective January 1, 1993. For taxable transfers over \$2.5 million but not over \$3.0 million, the rate would be 53 percent. For taxable transfers over \$3.0 million, the rate would be 55 percent. The phase out of the graduated rates and unified credit would be between \$10,000,000 and \$21,040,000. Also, the rate of tax on generation-skipping transfers would be 55 percent.

REDUCE DEDUCTIBLE PORTION OF BUSINESS MEALS AND ENTERTAINMENT EXPENSES FROM 80 PERCENT TO 50 PERCENT

Current Law

In general, deductions are allowable for ordinary and necessary expenditures paid or incurred in carrying on a trade or business or for the production or collection of income. Deductions are not allowed with respect to personal, living, or family expenses. Meals and entertainment expenses are deductible only if they are "directly related to" or "associated with" the active conduct of a taxpayer's trade or business. Meals and entertainment expenses are not deductible to the extent they are lavish or extravagant. Meals and entertainment expenses include, for example, food, beverages, entertainment at night clubs, cocktail lounges, theaters, sporting events and similar activities.

Allowable meal and entertainment expenses are deductible to the extent of 80 percent of cost. This reduction rule was added by Congress in 1986 to reflect the fact that all meals and entertainment inherently involve an element of personal living expense. Certain exceptions from the reduction rule apply (e.g., exceptions for expenses treated as compensation and reimbursed expenses).

Reasons for Change

The Administration believes that it is inappropriate to permit a deduction for the portion of these expenditures that is inherently personal in nature. Reducing the deductible percentage of otherwise allowable meal and entertainment expenses would reduce the amount of personal and living expense inherent in these expenditures that is deducted for federal income tax purposes.

Proposal

The proposal would reduce the deductible portion of otherwise allowable business meals and entertainment expenses from 80 percent to 50 percent for taxable years beginning after December 31, 1993.

DENY DEDUCTION FOR CLUB DUES

Current Law

In general, deductions are allowable for ordinary and necessary expenditures paid or incurred in carrying on a trade or business or for the production or collection of income. Deductions are not allowed with respect to personal, living, or family expenses. No deduction is permitted for club dues unless the taxpayer establishes that his use of the club was primarily for the furtherance of the taxpayer's trade or business. After this test is met, the taxpayer may then deduct only that portion of the dues which qualify as "directly related" to the active conduct of the taxpayer's trade or business. No deduction is permitted for an initiation or similar fee that is payable only upon joining a club if the useful life of the fee extends over more than one year. Such initiation fees are nondeductible capital expenditures.

Reasons For Change

Under present law, taxpayers can obtain a tax deduction for dues for a club (such as a country club) with respect to which a significant element of personal pleasure, enjoyment and social benefit is present. The Administration believes that it is inappropriate to permit a deduction for such expenditures because of the personal nature of these expenditures.

Proposal

Under the proposal, no deduction would be permitted for club dues for taxable years beginning after December 31, 1993. This rule would apply to all types of clubs, including business, social, athletic, luncheon, and sporting clubs. Specific business expenses (e.g., meals) incurred at a club would be deductible only to the extent they otherwise satisfy the standards for deductibility.

DENY DEDUCTION FOR EXECUTIVE PAY OVER ONE MILLION DOLLARS

Current Law

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

Reasons for Change

Given that current law does not provide any significant restrictions on deductions for compensation payments, there is no limitation on the amount of tax benefit provided for executive compensation. This unlimited tax benefit is particularly troubling in light of concerns that, in some cases, the compensation paid to corporate executives has increased despite a decline in business performance. In addition, there is concern that current law does not provide significant incentives for corporations to link compensation to business performance.

Proposal

The proposal would preclude a corporation from taking a deduction for compensation paid to an executive in excess of \$1 million per year. However, the \$1 million limitation would not apply to compensation payments that are linked to productivity. The Treasury is reviewing appropriate standards regarding this exception. Certain other payments also would be excluded from the deduction limit, such as payments made to a tax-qualified retirement plan and certain fringe benefits that are excludable from gross income by the executive. The proposal would be effective for taxable years beginning after December 31, 1993.

Effects of Proposal

The proposal would limit the tax benefit for salaries paid to executives and would provide a strong incentive for corporations to explicitly link compensation to productivity.

REDUCE COMPENSATION TAKEN INTO ACCOUNT FOR QUALIFIED RETIREMENT PLAN PURPOSES

Current Law

Section 401(a)(17) precludes a tax-qualified retirement or savings plan from providing benefits or making allocations on account of compensation in excess of \$235,840 (as indexed for 1993). Thus, if an employee has compensation in excess of the \$235,840 limit, the excess compensation cannot be used to determine the amount of the employee's benefit or allocation under a plan.

Reasons for Change

The tax benefit for tax-qualified retirement and savings plans is designed to give employers an incentive to provide reasonable levels of retirement income for their employees. A reexamination of the section 401(a)(17) limit is appropriate to ensure that the tax benefit is used primarily for the benefit of employees who, otherwise, might not save at adequate levels for retirement. In addition, it is appropriate to ensure that highly-compensated employees are not earning excessive retirement benefits through a tax-qualified plan.

Proposal

Under the proposal, the section 401(a)(17) limit would be reduced to \$150,000, for plan years beginning after December 31, 1993. As under current law, the section 401(a)(17) limit would be indexed for cost-of-living adjustments on an annual basis. Benefits accrued prior to the effective date for compensation in excess of the reduced limit would be grandfathered. Corresponding changes also would be made to other provisions that take into account the section 401(a)(17) limit.

Effects of Proposal

Although the reduction in the section 401(a)(17) limit would reduce the amount of benefits and contributions that could be provided through a tax-qualified plan for some employees, the affected individuals would be employees at higher compensation levels who are most able to save for retirement outside of the tax benefited qualified plan system. The proposal would not result in any cut-back of benefits already accrued because the reduced limit would be imposed only on compensation that is taken into account for determining benefits accrued in 1994 and thereafter.

The proposal's impact on employers' incentives to maintain a tax-qualified plan should not be significant. Even as limited under the proposal, tax-qualified plans would continue to provide an opportunity for meaningful retirement benefits on a tax-preferred

basis. In addition, it is possible that an employer could offset the effect of the reduction in the section 401(a)(17) limit by increasing other variables in a plan's formula. Such changes in the formula would increase benefits and contributions for lower-paid employees as well.

DISALLOW MOVING DEDUCTIONS FOR MEALS AND REAL ESTATE EXPENSES

Current Law

Any amount paid to or on behalf of an individual to move to a new residence is included in the individual's gross income as compensation for services. If the taxpayer's new job is at least 35 miles further from his former residence than was his former job, the taxpayer is permitted an itemized deduction for certain moving expenses that are incurred in connection with starting work at the new location. Deductible moving expenses include the costs of:

- (1) moving household goods;
- (2) travel, meals and lodging to transport the taxpayer and his family;
- (3) travel, meals and lodging for househunting trips;
- (4) meals and temporary lodging for up to 30 days' stay near the new job location; and
- (5) selling (or settling an existing lease on) the old residence and buying (or acquiring a lease on) the new residence.

The moving expense deduction is subject to a number of limitations. Generally, the deduction for househunting and temporary quarters may not exceed \$1,500. The deduction for selling, buying and settling leases may not exceed the net of \$3,000 less the amount claimed for househunting and temporary quarters. The moving expense deduction is not subject to the 2 percent floor on miscellaneous itemized deductions, but is subject to the overall limitation on itemized deductions.

Reasons for Change

The Administration believes that the cost of meals consumed during the course of a move should not be deductible. Moving does not generally increase the cost of meals significantly because the taxpayer would have eaten meals at either location. The costs of selling and buying homes are properly treated as reductions of the selling price (*i.e.*, amount realized) and additions to the purchase price (*i.e.*, basis). The costs of settling old leases and acquiring new leases are nondeductible personal expenses for most taxpayers.

Proposal

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

PROVISIONS AFFECTING BUSINESS

INCREASE CORPORATE TAX RATE FOR TAXABLE INCOME OVER TEN MILLION DOLLARS

Current Law

The highest marginal tax rate imposed on the income of corporations is 34 percent. This rate applies to income in excess of \$75,000. Rates of 15 and 25 percent apply to income ranges below \$75,000. A corporation with taxable income in excess of \$100,000 is required to increase its tax liability by the lesser of 5 percent of the excess or \$11,750. This increase in tax recaptures the benefits of the 15 and 25 percent rates.

Reasons for Change

The corporate income tax rates and the amount of taxes paid by corporations, as a percentage of both total federal revenues and gross domestic product (GDP), are relatively low by historical standards. The top marginal tax rate for corporations is 34 percent. By contrast, between 1979 and 1987, the top marginal rate for corporations was 46 percent. Prior to 1979, the rate was even higher. Similarly, the amount of income taxes paid by corporations is currently about 9 percent of total federal revenues and 1.5 percent of GDP. By contrast, in 1955, corporate income taxes were 27.3 percent of total federal revenues and 4.7 percent of GDP. Therefore, raising the top marginal tax rate for profitable corporations is an appropriate means to help reduce the budget deficits projected for the federal government.

Proposal

The proposal would provide a new 36 percent marginal tax rate on corporate taxable income in excess of \$10,000,000. A corporation with taxable income in excess of \$15 million would be required to increase its tax liability by the lesser of 3 percent of the excess or \$200,000. This increase in tax would recapture the benefits of the 34 percent rate in a manner analogous to the recapture of the benefits of the 15 and 25 percent rates. Because the 36 percent rate would apply only to income in excess of \$10,000,000, the vast majority of corporations would not be subject to the new rate. The 36 percent marginal rate would be effective for taxable years beginning on or after January 1, 1993. Penalties for the underpayment of estimated taxes, however, would be waived for underpayments of 1993 taxes attributable to the changes in tax rates.

DENY DEDUCTION FOR LOBBYING EXPENSES

Current Law

Under current law, businesses may deduct certain lobbying expenses. Deductible lobbying expenses include: amounts paid or incurred for direct communications with Congress or another legislative body concerning legislation of direct interest to the taxpayer in conducting a trade or business; the cost of communicating with a trade organization of which the taxpayer is a member in regard to relevant legislation; and a part of the dues for membership in an organization that engages in lobbying. No deduction is permitted for amounts paid or incurred for participation in political campaigns or grassroots lobbying.

Organizations that are exempt from taxation under section 501(c)(3) are subject to certain limitations on lobbying activities. Such organizations may make an election whereby they will not lose exempt status if their lobbying expenditures normally do not exceed a safe-harbor amount. Electing organizations are subject to an excise tax for lobbying expenditures in excess of the safe-harbor amount. Private foundations are subject to an excise tax on all lobbying expenditures. No tax is imposed on lobbying expenditures of trade associations and similar organizations. Corporations may deduct the part of their dues paid to such organizations that are for ordinary and necessary business expenses and for direct lobbying, but not for the part of their dues used for grassroots lobbying.

Reasons for Change

The deduction for lobbying expenses inappropriately benefits corporations and special interest groups for intervening in the legislative process.

Proposal

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

REQUIRE SECURITIES DEALERS TO MARK TO MARKET

Current Law

Under Treasury regulations, dealers' inventories of marketable securities may be valued at market, at cost, or at the lower of cost or market for purposes of computing taxable income.

The market method of inventory valuation (often referred to as the "mark-to-market" method) requires the taxpayer to determine the market value of its inventory at the end of each taxable year and include all unrealized inventory gains and losses in its income for the year. The market method tends to give the most accurate measure of a taxpayer's annual income, but it works best if the taxpayer's inventory is composed of property that can be readily valued at the end of each taxable year.

Because inventories of most businesses are difficult to value, however, many taxpayers use the cost method of inventory valuation (often referred to as the "historical cost" method). Under this method, a taxpayer values its inventory at cost, and does not recognize any increases or decreases in the inventory's value until the inventory is sold. For most businesses, the cost of the taxpayer's inventory will ordinarily be less than its market value and inventory levels will ordinarily increase over time. Thus, the taxpayer's annual income computed under the cost method will tend to be less than when computed under the market method.

Under the lower-of-cost-or-market method of inventory valuation (LCM), a taxpayer values each item of inventory at its market value or at its cost, whichever is lower at the end of each taxable year. Thus, the LCM method permits the taxpayer to deduct unrealized losses without requiring any unrealized gains to be included in income.

When Treasury regulations regarding securities dealers' inventories were issued, the lower-of-cost-or-market method conformed to the best financial accounting practice in the industry, and securities dealers generally valued their securities inventories on that basis in their financial statements. Because the LCM method provides a lower annual income, compared to either the market method or the cost method, it was considered a very conservative method of financial accounting. Since 1973, however, generally accepted accounting principles (GAAP) have required securities dealers to mark their inventories to market to more accurately measure financial income and net worth.

Reasons for Change

Inventories of marketable securities are easily valued at year end, and in fact are currently valued by securities dealers in computing their income for financial statement purposes and in adjusting their inventory to an LCM basis for federal income tax

purposes. The cost method and the LCM method tend to provide a lower taxable income compared to the market method that securities dealers use to report their income to shareholders, creditors and regulators. The market method represents the required GAAP method in the trade or business of dealing in securities and is the method that provides the most accurate measure of the income of a securities dealer.

Proposal

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

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

PROHIBIT DOUBLE-DIP RELATED TO FSLIC ASSISTANCE

Current Law

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

Before it was amended by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), a special tax rule exempted financial assistance received by a thrift institution from the Federal Savings and Loan Insurance Corporation (FSLIC) from the thrift's income and prohibited a reduction in the tax basis of the thrift's assets on account of the receipt of the assistance. The FSLIC entered into a number of assistance agreements in which it agreed to provide loss protection to acquirers of troubled thrift institutions by compensating them for the difference between the book value and sales proceeds of the "covered assets." "Covered assets" typically are assets that were classified as nonperforming or troubled at the time of the assisted transaction. Many of these covered assets are also subject to yield maintenance guarantees, under which the FSLIC guarantees the acquirer a minimum return or yield on the value of the assets. The assistance agreements also generally grant the FSLIC the right to purchase covered assets at market or book value.

In addition, many of the assistance agreements permit the FSLIC to order assisted institutions to write down the value of covered assets on their books to fair market value in exchange for a payment in the amount of the write-down. It was not clear under prior law whether FSLIC assistance should be taken into account in determining the amount of an institution's tax loss on the sale or other disposition of an asset or deduction in connection with the write-down of a loan.

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

Congress enact clarifying legislation disallowing these deductions.

Reasons for Change

Allowing tax deductions for losses on covered assets that are compensated for by FSLIC assistance gives thrift institutions an inappropriate incentive to hold these assets and to minimize their value when sold. The FSLIC, and not the institution, bears the economic burden corresponding to any reduction in value because it is required to reimburse the thrift for the loss. However, the tax benefit to the thrift and its affiliates increases as tax losses increase. The institution, therefore, has an incentive to minimize the value of covered assets in order to maximize its tax loss and the attendant tax savings.

Proposal

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

The proposal would apply to FSLIC assistance credited on or after March 4, 1991, with respect to (1) assets disposed of and charge-offs made in taxable years ending on or after March 4, 1991, and (2) assets disposed of and charge-offs made in taxable years ending before March 4, 1991, but only for the purpose of determining the amount of any net operating loss carryover to a taxable year ending on or after March 4, 1991. For this purpose, assistance generally would be considered to be credited when the taxpayer made an approved debit entry to a Special Reserve Account required to be maintained under the assistance agreement to reflect the asset disposition or charge-off.

EXTEND CORPORATE ESTIMATED TAX RULES

Current Law

Under current law, a corporation is subject to an addition to tax for any underpayment of estimated tax. For taxable years beginning after June 30, 1992, and before January 1, 1997, a corporation generally does not have an underpayment of estimated tax if it makes four timely estimated tax payments based on 97 percent of (1) its current year tax liability, or (2) its tax liability computed by annualizing income as of the month or quarter ending immediately prior to its estimated tax payment due dates.

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

Upon expiration, in 1997, of the 97 percent requirement applicable for estimated payments based on a corporation's current year tax liability or its liability based on annualized income, a 91 percent requirement will apply.

Reasons for Change

The Administration believes that the corporate estimated tax requirements generally applicable to 1993, 1994, 1995, and 1996 taxable years should be made permanent. Under the proposal, corporate estimated tax payments will more accurately reflect ultimate tax liabilities for a particular taxable year.

Proposal

The proposal would permanently extend the 97 percent requirement applicable for estimated tax payments based on a corporation's current year tax liability or its liability based on annualized income. The proposal would not alter rules permitting the payment of estimated taxes based on a corporation's tax liability for its preceding taxable year.

LIMIT POSSESSION TAX CREDIT TO 65 PERCENT OF COMPENSATION PAID

Current Law

Domestic corporations with business operations in United States possessions may elect under section 936 to eliminate the United States tax on certain income related to their possession-based operations. The credit spares the electing corporation United States tax whether or not it pays income tax to the possession.

In order to qualify for the section 936 credit, a domestic corporation must derive at least 75 percent of its gross income from the active conduct of a trade or business within a possession over a three-year period, and at least 80 percent of the corporation's gross income must be derived from sources within a possession during that period.

Reasons for Change

Section 936 was enacted to foster economic development in the possessions, principally Puerto Rico. Many studies conducted over the past 15 years, however, have indicated that a disproportionate share of the tax benefits attributable to section 936 is realized by intangible-intensive industries that create relatively few jobs in the possessions. For instance, Treasury data indicate that in 1989 the tax expenditure for each job that pharmaceutical corporations created in Puerto Rico was \$66,081, and that the pharmaceutical industry enjoyed 50 percent of the section 936 tax benefits in that year. Overall, the average tax benefit per employee in that year was \$22,375, or 109 percent of average compensation paid to those employees. Data of this nature suggests that while section 936 has created employment in Puerto Rico, the number of jobs created is too small in relation to the tax expenditure.

Linking the credit more directly to wages paid in the possession would both reduce the revenue cost of the provision and more effectively encourage employment in the possessions.

Proposal

The section 936 credit would be limited to 65 percent of the wages the possessions corporation pays to its employees in the possession. For this purpose, wages are defined by reference to the Federal Unemployment Tax Act (FUTA) definition of wages. The amount of wages taken into account for each employee would be limited to the amount of wages subject to federal social security withholding (currently \$57,600). Related possessions corporations would be permitted to consolidate for purposes of determining their section 936 credit. This proposal would be effective for taxable years beginning after December 31, 1993, except that, for 1994 and 1995, possessions

corporations may elect to claim a reduced credit not linked to compensation. Under this alternative, the credit will be limited to 80 percent of the current law credit in 1994 and 60 percent in 1995.

Effects of Proposal

Possessions corporations that have created a relatively large number of jobs will continue to enjoy the tax credit that they now receive. Possessions corporations for which tax credits exceed 65 percent of payrolls will lose some of their tax benefits unless they expand their Puerto Rican employment. The result should be a much more cost-effective possessions credit.

PROVISIONS AFFECTING INTERNATIONAL BUSINESSES

ELIMINATE WORKING CAPITAL EXCEPTION FOR FOREIGN OIL AND GAS AND SHIPPING INCOME

Current Law

United States taxpayers may claim a foreign tax credit for foreign taxes paid. The foreign tax credit is limited to the taxpayer's United States tax liability on foreign source taxable income. The foreign tax credit limitation is computed separately for specified categories of income, to prevent taxpayers from "cross-crediting" high foreign taxes paid on certain types of income to reduce United States tax on passive types of income, which typically are subject to low foreign tax.

One of the separate limitation categories is the "passive" category. Although most income of a passive nature falls into this category, interest on bank deposits or on other temporary investments of working capital in connection with foreign oil and gas extraction income (FOGEI), foreign oil related income (FORI), or shipping income is excluded from the passive category. No other industries enjoy a working capital exception.

Current law also imposes a special limitation on the amount of foreign oil and gas extraction taxes that may be credited against the United States tax on FOGEI. Passive income related to foreign oil and gas extraction taxes is included in the computation of this limitation. This increases the amount of the foreign tax credit that may be claimed against United States tax on such income.

Taxpayers' ability under current law to cross-credit taxes on certain passive income earned in connection with FOGEI, FORI, or shipping income reduces the residual tax that the United States may collect on such income. The inclusion of passive income in computing the special FOGEI foreign tax credit limitation has the same effect.

Reasons for Change

Current law creates incentives for taxpayers in the oil and gas and shipping industries to keep their working capital abroad rather than in the United States. The Administration believes that these incentives are inappropriate. In addition, current law provides more favorable foreign tax credit treatment for income associated with foreign oil and gas or shipping activities than for income earned abroad by other United States industries. The Administration believes that there is no sound policy reason for this difference in treatment and that foreign oil and gas and shipping activities should be put on an equal footing with other industries.

Proposal

The proposal would prevent the cross-crediting of foreign taxes on FOGEI, FORI, and shipping income by placing investment income related to these types of income in the passive category for foreign tax credit limitation purposes. In addition, the proposal would exclude passive income related to foreign oil and gas extraction from the computation of the FOGEI foreign tax credit limitation. The proposal would apply to income earned in taxable years beginning after December 31, 1993.

TRANSFER PRICING INITIATIVE

Current Law

Section 6662 imposes a penalty in the amount of 20 percent of any underpayment attributable to certain section 482 allocations that constitute substantial valuation misstatements. For this purpose, a substantial valuation misstatement arises if (1) the transfer price for any property or services (or for the use of property) claimed on a return is 200 percent or more (or 50 percent or less) of the amount determined under section 482 to be the arm's length price, or (2) the net section 482 adjustment exceeds \$10 million. In the case of a gross valuation misstatement (as defined in section 6662(h)), the penalty is increased to 40 percent.

Section 482 adjustments are excluded for purposes of section 6662 if there was reasonable cause for the taxpayer's determination of the transfer price and the taxpayer acted in good faith. The requirements to satisfy this exclusion are not set forth in the statute.

Reasons for Change

In part, because no definition of the reasonable cause and good faith exclusion has been provided by statute, the IRS has not attempted to apply the penalty under section 6662(e) since the provision was enacted in 1990. By statutorily defining this exclusion, the IRS will have sufficient guidance to apply the penalty.

In the absence of an effective penalty, many multinational corporations appear to establish their transfer prices without reference to the arm's length standard. Moreover, taxpayers whose transfer pricing results are under examination often feel little obligation to provide the examiner with detailed data demonstrating that their prices led to an arm's length result. As a result, the burden of establishing whether a particular intercompany price was arm's length effectively falls on the examiner in many cases. This determination normally includes obtaining data of comparable uncontrolled transactions and applying a transfer pricing methodology under the section 482 regulations to such data.

Proposal

Section 6662(e) would be amended to provide that the reasonable cause and good faith exclusion will be satisfied if the taxpayer provides contemporaneous documentation demonstrating the application of one or more reasonable transfer pricing methodologies to the taxpayer's controlled transactions. In order for the application of transfer pricing methodologies to be reasonable, any procedural or other requirements imposed by section 482 regulations with respect to the application of such method must be observed

and documented. For example, if adjustments required under a particular method were not made, the taxpayer's application of such method would not be reasonable. In addition, methods other than those specifically prescribed in the section 482 regulations may be reasonable if the taxpayer could establish that, at the time of the controlled transactions, the prescribed methods would not be likely to lead to an arm's length result, and that the method actually applied was likely to lead to such a result. The proposal would be effective for taxable years beginning after December 31, 1993.

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

Effects of Proposal

The proposal should improve compliance for two reasons. First, compliance should improve, given the substantial penalty that otherwise could be imposed, because taxpayers will have a strong incentive to apply and document a methodology that leads to an arm's length result. Second, such documentation would enhance the effectiveness of examinations. Instead of devoting resources to identifying transfer pricing issues, and then developing comparable data to support application of a methodology, examiners would be able to focus immediately on assessing the validity of the methodology and supporting data that the taxpayer employed.

In addition, the transfer pricing enforcement initiative should yield a substantial improvement in tax collections from taxpayers who use abusive transfer prices to shift profits beyond the United States taxing jurisdiction.

ALLOCATE RESEARCH AND EXPERIMENTATION (R&E) EXPENSE TO PLACE OF PERFORMANCE AND TREAT ROYALTIES AS PASSIVE INCOME FOR PURPOSES OF FOREIGN TAX CREDIT LIMITATION

Current Law

United States taxpayers may claim a foreign tax credit for foreign income taxes paid. The foreign tax credit is limited to the United States tax liability on foreign source taxable income. To compute this limitation, deductions for expenses must be allocated to gross income from domestic and foreign sources. Allocation of an expense to foreign source gross income reduces foreign source taxable income and thus reduces the amount of foreign tax credit that a taxpayer may claim. Allocation of an expense to domestic source income does not affect the foreign tax credit limitation.

A Treasury regulation issued in 1977 provides generally that research and experimentation (R&E) expense may be allocated to domestic and foreign source gross income based on either the taxpayer's relative amounts of domestic and foreign source gross income in the appropriate product category or the taxpayer's relative gross sales receipts from domestic and foreign sources in the product category. If the sales method is chosen, the taxpayer may first allocate 30 percent of its R&E expense to gross income from the location where most of its R&E activity is conducted (usually the United States, in the case of a United States taxpayer).

Since 1981, the 1977 Treasury regulation has been modified eight times by temporary legislation. Each temporary legislative rule permitted direct allocation of a substantial percentage (ranging from 50 percent to 100 percent) of the expense associated with United States-based R&E to domestic source income, whether or not the expense actually related to such income. The most recent statutory rule permitted taxpayers to allocate 64 percent of United States-based R&E expense to domestic source income and 64 percent of foreign-based R&E expense to foreign source income. This statutory rule expired in mid-1992, but an IRS announcement permits taxpayers to continue to apply the 64 percent rule for an additional 18-month period. A direct allocation of United States-based R&E expense to domestic source income encourages taxpayers to conduct R&E in the United States by ensuring that this expense does not reduce the foreign tax credit limitation.

Passive foreign source income is subject to a separate foreign tax credit limitation that prevents taxpayers from sheltering passive income (usually subject to low foreign taxes) from residual United States tax by "cross-crediting" excess foreign taxes paid on other types of foreign source income. The separate limitation for passive income applies to foreign source royalties, with two exceptions. First, royalties received from an unrelated person in the conduct of an active trade or business are excluded from the passive limitation category; these royalties are subject instead to the general foreign tax

credit limitation or one of several other separate limitations for specified types of business income. Second, certain royalties received from foreign affiliates are categorized on a "lookthrough" basis that often results in the royalties being treated as general limitation income. Since royalties tend to be subject to low rates of foreign tax, the treatment of royalties as general limitation income often permits taxpayers to offset residual United States tax on foreign source royalties with excess foreign taxes paid on other items of general limitation income.

Reasons for Change

The 1977 Treasury regulations governing the allocation of R&E expense seek to allocate R&E expense based on the "factual relationship" of R&E expense to gross income. Current R&E expense generally relates to future gross income, however, rather than the current gross income to which it must be allocated. Thus, application of the "factual relationship" principle is difficult and requires complex regulatory rules. Moreover, the frequent statutory modifications of the 1977 regulatory rules have added both complexity and uncertainty to the allocation of R&E expense. Accordingly, there is a need both to simplify the R&E allocation rules and to make them permanent. Eliminating complex, changing rules would promote compliance. A permanent rule permitting a direct allocation of all expense for United States-based R&E to domestic source income would encourage United States corporations to perform research in the United States.

The treatment of substantial portions of foreign source royalty income as general limitation income for foreign tax credit limitation purposes (under either the "active royalty" exception or the "lookthrough" rule) can result in a tax preference for licensing of intangible property to a foreign person for use in production activities abroad. This occurs because royalties which are treated as general limitation income but incur low rates of foreign tax can absorb high foreign taxes paid on other general limitation income. As a result, the royalty income can avoid residual United States tax. In contrast, royalties or other income received for the use of intangible property in domestic production activities generally cannot be similarly sheltered.

The treatment of all foreign source royalty income as income within the separate limitation category for passive income would remove the preference for foreign licensing of intangible property. Placement of royalties in the passive category would generally eliminate existing opportunities for cross-crediting of high foreign taxes paid on other business income against low-taxed royalty income.

Proposal

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

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

Effects of Proposal

The proposal would eliminate the existing tax preference for licensing intangible property for use in foreign production activities. In addition, the rules governing the allocation of R&E would be simplified and would encourage the conduct of R&E in the United States.

ENHANCE EARNINGS STRIPPING AND OTHER ANTI-AVOIDANCE RULES

Current Law

Under current law, a thinly capitalized corporation may not claim a current deduction for excessive interest paid to a related party if the interest income is exempt from United States taxation. These "earnings stripping" rules apply, for example, if a foreign parent corporation capitalizes a United States subsidiary with excessive amounts of debt and the interest payments on the debt are wholly or partially exempt from 30 percent withholding tax under a United States income tax treaty.

The earnings stripping rules apply to a corporation only if it has a debt-equity ratio in excess of 1.5 to 1. In the case of such a corporation, an interest deduction is disallowed to the extent that the corporation's net interest expense exceeds 50 percent of its adjusted taxable income for the year. Disallowed interest expense may be carried forward indefinitely and deducted in a taxable year in which the corporation has "excess limitation" (i.e., net interest expense in an amount less than 50 percent of its adjusted taxable income).

Reasons for Change

The earnings stripping rules may be easily circumvented if the rules are not applied to unrelated party debt guaranteed by a related party. In general, the application of the earnings stripping rules in such cases is necessitated by the close economic equivalence between the guaranteed debt and a loan from the unrelated lender to the related party, followed by a separate loan from the related party to the debtor corporation.

Proposal

Any loan from an unrelated lender that is guaranteed by a related party would be treated as related party debt for purposes of the earnings stripping rules. Except as provided in regulations, a guarantee would be defined to include any arrangement under which a person directly or indirectly assures (on an unconditional or contingent basis) the payment of another's obligation. For purposes of determining whether the interest paid on the guaranteed debt is exempt from United States tax, the fact that the unrelated lender is subject to net basis United States taxation (as opposed to United States withholding tax) on its interest income would not be taken into account. This proposal would apply to any interest paid or accrued in taxable years commencing after December 31, 1993.

Other provisions would be adopted to prevent the use of back-to-back loans and

other tax avoidance arrangements. These provisions would apply beyond the earnings stripping rules.

Effects of Proposal

The proposal would eliminate current law incentives to use guaranteed unrelated party debt and other arrangements to avoid the application of the earnings stripping rules and other provisions of the Code.

REQUIRE CURRENT TAXATION OF CERTAIN EARNINGS OF CONTROLLED FOREIGN CORPORATIONS

Current Law

Generally, the Code does not tax income earned by a foreign corporation until the earnings are repatriated to United States shareholders. The Code provides exceptions to this general deferral rule, including the subpart F rules for controlled foreign corporations (CFCs) and the passive foreign investment company (PFIC) rules.

Under the subpart F rules, a 10 percent United States shareholder of a CFC is required to include in income currently its pro rata share of the "subpart F income" of the CFC. A CFC generally is defined as a foreign corporation more than 50 percent owned by 10 percent United States shareholders. "Subpart F income" generally includes passive income and certain types of active income considered to be particularly mobile; however, it does not include most types of active business income.

Under the PFIC rules, a United States shareholder of a PFIC is subject to provisions designed to eliminate the benefit of deferral of United States tax on the shareholder's pro rata share of the PFIC's total undistributed earnings. These provisions apply regardless of the United States shareholder's percentage ownership. A PFIC is any foreign corporation (whether or not a CFC) if (1) 75 percent or more of its gross income for the taxable year is passive income, or (2) 50 percent of its assets produce, or are held for the production of, passive income. For this purpose, passive income generally does not include active banking or insurance income. A United States shareholder of a PFIC may elect to include currently in income its pro rata share of the PFIC's total earnings. If this election is not made in a timely manner, the United States shareholder is subject to an interest charge when it receives certain distributions of PFIC earnings or disposes of PFIC stock.

Reasons for Change

Under current law, United States shareholders of CFCs may defer United States tax on the CFC's earnings that are not subpart F income, unless the earnings are repatriated or a PFIC inclusion is triggered. Many CFCs are able to defer tax indefinitely by managing their passive income and assets so as to avoid the PFIC thresholds. The Administration believes that the unlimited deferral of tax on earnings not reinvested in an active business contributes to the transfer of business activities to non-United States jurisdictions and is difficult to justify on competitiveness or other policy grounds.

Proposal

The proposal would require 10 percent United States shareholders of certain CFCs to include in income currently their pro rata shares of a specified portion of the CFC's current and accumulated earnings. The proposal would apply to a CFC (including a CFC that is a PFIC) holding passive assets representing 25 percent or more of the value of the CFC's total assets. The portion of current and accumulated earnings subject to inclusion ("includible earnings") would be the lesser of (1) total current and accumulated earnings and profits, or (2) the amount by which the value of the CFC's passive assets exceeds 25 percent of the value of its total assets. Includible earnings would be adjusted to account for amounts previously taxed. For this purpose, passive assets would be defined as under the PFIC rules (including the definition of passive income thereunder).

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

Effects of Proposal

The proposal would eliminate deferral of United States tax on a portion of CFC earnings invested in passive assets, and thus would encourage the repatriation of active earnings that are not reinvested in an active business.

ENERGY PROVISIONS

PROVIDE A MODIFIED BTU TAX

Current Law

The United States currently does not impose a broad-based energy tax. The United States does impose an excise tax on motor fuels (gasoline, special motor fuels, and diesel fuel) used for highway transportation; special motor fuels used in motorboats; and diesel fuel used in trains. The United States also imposes an excise tax on coal from domestic mines and an excise tax on crude oil received at domestic refineries and petroleum products entered into the United States. With the exception of the motor fuels tax, all energy taxes are minor. For the most part, these are dedicated revenues that are deposited in various trust funds. The motor fuels tax also has a deficit reduction portion that is not dedicated, but is retained in the General Fund.

Reasons for Change

A broad-based energy tax would help reduce the deficit and put the government on a pay-as-you-go basis for needed public programs. In addition, the tax would advance three goals: reduction of environmental damages, energy conservation, and reduced dependence on foreign sources of energy. The tax would encourage energy efficiency and fuel mix choices better reflecting the true environmental and security costs of energy use. Moreover, an energy tax would help move the United States economy from income-based to consumption-based taxation, with attendant benefits to saving, investment, and returns to work effort.

Proposal

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

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

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

Effects of Proposal

The proposal would raise substantial revenues for deficit reduction while advancing environmental, energy conservation and security objectives. In particular, the proposal would reduce carbon emissions and vehicle use, and reductions in consumption of oil would come disproportionately from imports. With the indexation feature, revenues from the proposal (in constant dollars) would be relatively stable.

EXTEND MOTOR FUELS EXCISE TAX

Current Law

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

The rate of tax on motor fuels is 14.1 cents per gallon on gasoline and special motor fuels and 20.1 cents per gallon on diesel fuel and includes a deficit reduction rate of 2.5 cents per gallon. The deficit reduction rate is also imposed on diesel fuel used in trains. The deficit reduction rate does not apply after September 30, 1995.

Reasons for Change

An extension of the expiring 2.5-cents-per-gallon tax on motor fuels would raise substantial revenue and advance three goals: reduction of environmental damages, energy conservation, and reduced dependence on foreign sources of energy.

Proposal

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

COMPLIANCE INITIATIVES

SERVICE INDUSTRY NON-COMPLIANCE INITIATIVE

Current Law

Under current law, payors are required to file information returns with the IRS indicating the names and tax identification numbers of persons to whom they have made annual payments of \$600 or more in the course of the payor's trade or business, as well as the amounts paid. Payors are also required to furnish this information to the payees. Treasury regulations generally provide, however, that payments to a corporation need not be reported.

Reasons for Change

Payors cannot easily determine whether a business is actually conducted in corporate form because payees can simply claim to be incorporated, and payors are not required to verify such claims. Moreover, the level of voluntary tax compliance among corporations that provide services appears to be lower than that of most other corporate businesses due to nonfilers and underreporters. Therefore, the regulatory exception for corporations has significantly reduced the benefits possible under an information reporting program.

Proposal

The proposal would require that annual payments by a payor of \$600 or more for services purchased in the course of the payor's trade or business be reported to the IRS by a payor for all service providers, including corporations. The proposal would apply to payments for services made by a payor after December 31, 1993.

Effects of Proposal

The IRS's ability to identify nonfilers and require backup withholding would be substantially improved. Moreover, experience with information reporting has shown that when taxpayers know that the IRS has received information on payments made to them, they are more likely to file tax returns and to accurately report their income. Accordingly, the proposal should reduce the number of nonfilers and the amount of underreporting by service providers. Although payors would be required to furnish information for more service providers, payors generally must have reporting systems in place under current law. Indeed, some payors have suggested that it would be less burdensome to report all payments, rather than to except payments made to corporate service providers.

RAISE STANDARD FOR ACCURACY-RELATED AND PREPARER PENALTIES

Current Law

A taxpayer generally may avoid a substantial understatement or negligence penalty for an underpayment of tax attributable to a position taken on a tax return if the position is not frivolous and is adequately disclosed. An income tax return preparer generally may avoid a preparer penalty for an understatement of tax due to a position on an income tax return if the position is not frivolous and is adequately disclosed. A "frivolous" position for these purposes is one that is patently improper.

Reasons for Change

Permitting taxpayers and preparers to avoid penalties by disclosure of return positions as long as they are not "patently improper" may not sufficiently discourage the reporting of unreasonable return positions. Taxpayers and preparers should try to comply with the tax laws in a reasonable manner.

Proposal

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

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

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

MODIFY TAX SHELTER RULES FOR PURPOSES OF THE SUBSTANTIAL UNDERSTATEMENT PENALTY

Current Law

Under current law, the substantial understatement penalty applies to any portion of an underpayment of income tax required to be shown on a return that is attributable to a substantial understatement of income tax.

Generally, the amount of an "understatement" of income tax is the excess of the tax required to be shown on the return, over the tax shown on the return (reduced by any rebates of tax). An understatement is considered "substantial" if it exceeds the greater of (1) 10 percent of the tax required to be shown on the return, and (2) \$5,000 (\$10,000 in the case of a corporation other than an S corporation or a personal holding company).

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

A tax shelter is any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement if the principal purpose of such partnership, entity, plan or arrangement is to avoid or evade federal income tax. An item of income, gain, loss, deduction or credit is a "tax shelter item" if the item is directly or indirectly attributable to the principal purpose of a tax shelter.

Reasons for Change

The substantial understatement penalty may not effectively deter certain abusive tax shelter transactions that are structured with little anticipated profit apart from the expected tax benefits. Taxpayers could assert that these types of tax shelter transactions have "economic substance" because of the existence of nominal profit potential coupled with some form of economic risk. As long as they are able to make this assertion, taxpayers may be able to avoid the penalty by arguing that they reasonably believed the tax treatment of the tax shelter items was more likely than not the proper treatment.

The Administration believes that to the extent a substantial understatement of income tax is determined to be attributable to tax shelter items, taxpayers should not be

able to avoid the penalty in situations where the expected tax benefits of the shelter are significantly greater than the anticipated pre-tax economic profit.

Proposal

The proposal would strengthen the requirements for reducing the amount of an understatement in the case of tax shelter items. Under the proposal, an understatement would be reduced by the portion of the understatement attributable to a tax shelter item only if, in addition to satisfying existing requirements, the taxpayer could demonstrate that the reasonably anticipated tax benefits from the shelter did not significantly exceed the reasonably anticipated pre-tax economic profit from the shelter (over the reasonably anticipated life of the shelter).

Thus, an understatement would be reduced by the portion of the understatement attributable to a tax shelter item only if (1) there was substantial authority for the treatment of the item claimed on the return; (2) the taxpayer reasonably believed that the claimed treatment was more likely than not the proper treatment; and (3) the reasonably anticipated tax benefits from the shelter did not significantly exceed the reasonably anticipated pre-tax economic profit from the shelter.

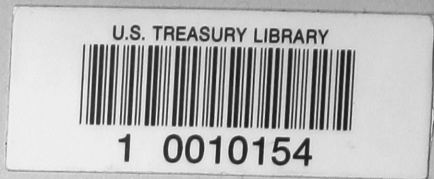
This proposal would apply to tax returns due (without regard to extensions) on or after December 31, 1993.

MISCELLANEOUS

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

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