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TREASURY NEWS



Department of the Treasury

Washington, D.C.

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January 28, 1992

President Bush's Plan to Stimulate Economic Recovery, Promote Long-term Growth, and Expand Opportunity

Overview

America's economy faces two challenges: we must spur economic recovery and we must invest in long-term growth and global competitiveness. Spurring the recovery requires short-term solutions with long-range impact. And ensuring long-term growth demands long-term thinking, planning and investing in our future.

The Administration's economic agenda stimulates recovery, promotes growth and expands opportunity. It contains bold policy initiatives to address today's challenges and take advantage of tomorrow's opportunities.

The proposal includes:

- o Job-creating growth incentives for now and the future
- o Reduction of barriers to long-term saving and investment
- o Incentives to expand opportunity for American employees, entrepreneurs and families
- o Fiscal restraint that sticks to pay-as-you-go budgeting
- o Help for home buyers to spark recovery and ensure long-term financial security for families
- o Forward-looking policies to promote global competitiveness.

Fact Sheet

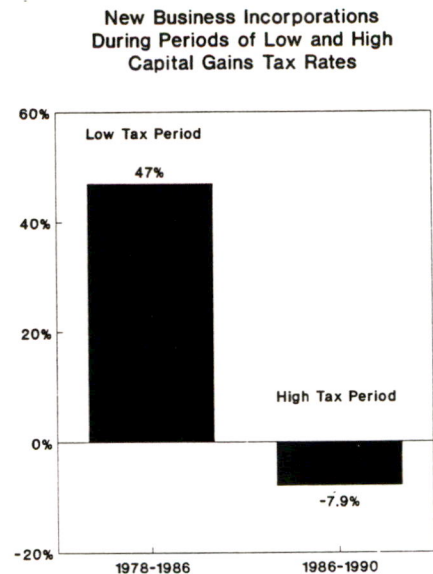
STIMULATING ECONOMIC RECOVERY

The Administration's proposals will have the strong, stimulative effect needed to create investment and jobs, as well as incentives for families to buy their first home, and save for their children's education.

A. Increasing Investment -- Jobs Today; Opportunity Tomorrow

The Administration's proposals would rapidly improve the nation's investment climate.

- o Lowering the capital gains tax rates will immediately increase asset values and unlock investments now immobilized by America's punitive capital gains tax rates; it also will attract needed capital investment in America's factories and start-up ventures to help ensure growth in the future.



- o Comprehensive measures to revive depressed real estate markets will create opportunities in that sector and for many other industries which depend on its vitality, such as home furnishings and appliances, building materials, construction, and banking.
- o Solving the credit crunch will unleash capital for jobs and investment. The Administration's efforts to work with regulators and return balance to bank lending and regulation, combined with its support for lower real interest rates and sensible credit standards for borrowers, will improve credit availability.
- o Enacting the Administration's banking reform proposals, which the Congress failed to do last year, will strengthen America's financial system and increase competitiveness. It is the most significant way to improve credit conditions.

B. Incentives for Business Investment and Capital Improvement

The Administration's proposals will provide powerful incentives to encourage businesses to undertake investments now and plant the seeds of growth for tomorrow.

- o Accelerated depreciation for machinery and capital equipment will provide immediate incentives for new investment and leave more money in the hands of businesses that are trying to increase productivity.
- o Improvements in the corporate alternative minimum tax will spur capital-intensive industries -- such as airlines, chemicals, and motor vehicles -- to buy equipment to modernize, expand capacity and meet the challenge of international competition.
- o Removing tax code impediments to pension fund investment in real estate will increase the efficiency of pension fund investments and lower associated transaction costs.

C. Help For Home Buyers

By making it easier for families to purchase their first home, the Administration's proposals will spark a recovery in home building and related sectors, while ensuring long-term financial security for Americans.

- o Providing a \$5,000 tax credit for first-time home buyers and flexible IRAs will help families who can afford mortgage payments, but still need money for downpayments and closing costs, to take advantage of the lowest mortgage interest rates in nearly 20 years. Having more qualified buyers in the market will help those trying to sell their homes.
- o Extending authority to issue mortgage revenue bonds will increase the availability of mortgage funds, making it easier for families of low- and moderate-income to obtain financing.

Fact Sheet

PROMOTING LONG-TERM ECONOMIC GROWTH

While providing short-term economic stimulus, the Administration's proposals maintain the President's commitment to long-term policies of market-driven growth and competitiveness. The Administration's package will reduce barriers to investment and saving, encourage entrepreneurship, foster innovation, and promote saving for education and other long-term goals.

A. Encouraging Investment for Long-term Growth

Investment in capital of all kinds -- equipment, modernized plants, research, and an improved work force -- generates jobs, promotes growth and improves our standard of living over the long term. Administration policies will encourage increased investment in the United States.

- o Lowering the capital gains tax rates by excluding 45 percent of the capital gain on assets held three or more years; 30 percent of the gain on assets held two or three years; and 15 percent of the gain on assets held at least one year. A 45 percent exclusion would effectively cut the capital gains tax to 15.4 percent for taxpayers now subject to a 28 percent capital gains rate.

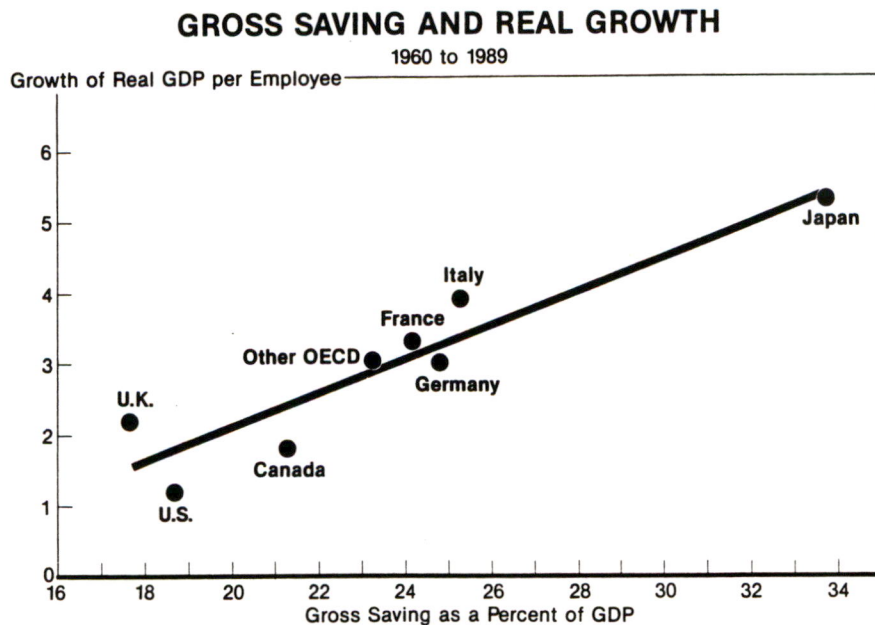
This will reduce the cost of capital, expand opportunities for new businesses and assure more jobs, productivity improvements, and higher standards of living in the future.

- o Making the Research and Experimentation Tax Credit permanent will stimulate private sector R&E investment and the technological innovations upon which America's long-term prosperity and quality of life depend.
- o Adjustments to the Corporate Alternative Minimum Tax (AMT) will lessen disincentives to new corporate investment in capital-intensive industries in the U.S.
- o Federal enterprise zones will introduce a new era of public/private partnerships to create special investment opportunities in America's economically distressed cities and rural areas.
- o Deductibility of interest on student loans and flexible IRAs will give financial assistance to those Americans striving to further their education or learn new vocational skills, thus improving America's "human capital."

- o Following the Treasury's corporate tax integration study, the Administration will promote discussion of removing the double taxation of corporate dividends, thereby lowering the cost of capital and increasing American competitiveness.

B. Reducing Barriers to Saving

Statistics demonstrate a positive correlation between saving rates and long-term growth. The United States needs to increase its savings to fund investment and ensure U.S. competitiveness. The Administration proposals will expand the pool of available savings, lowering the cost of capital for American investment.



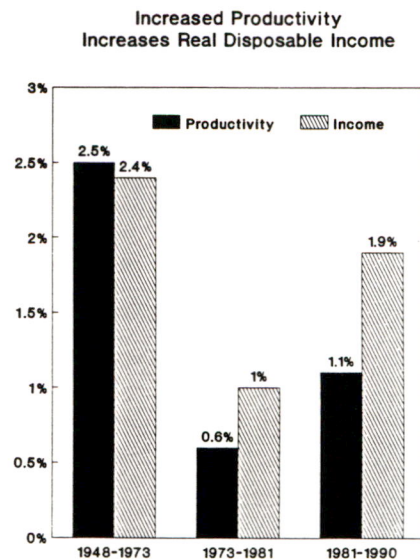
August 21, 1991-A870

- o Strict spending discipline and deficit control, provided by the 1990 Budget Agreement, is the single most important way to stop the federal government's unacceptable drain on the national savings pool. The American people live within their means; the government must do the same.
- o Reduction in tax rates applicable to capital gains will increase investment returns and create incentives for saving.
- o Enhancing existing IRAs and creating new, Flexible IRAs will create more attractive saving vehicles for retirement, education, medical expenses and other long-term financial goals.

C. Improving the Business Climate

Administration policies will improve the overall climate for job-creating investments by addressing vital issues for entrepreneurs.

- o The Administration will extend policy support for continued low interest rates, which are now at the lowest levels in nearly 20 years.
- o Cost-effective, market-oriented business regulation, and deregulation will be undertaken when appropriate.
- o Open trade and investment regimes, accomplished by successful conclusions of the Uruguay Round of multi-lateral trade negotiations and the North American Free Trade Agreement, will create economic growth and business opportunities for American firms.
- o Continued support for growth-oriented, market-driven economic policies helps increase investment and productivity. Business flourishes most in America when the government's role is limited. And greater productivity leads to increased prosperity and higher wages.
- o Investment in America's human capital, through improving the nation's education system and addressing serious problems such as drugs and crime, will increase the competitiveness of America's work force.
- o Investment in our nation's physical infrastructure, provided by the Administration's recently-enacted Surface Transportation Act of 1991, is creating jobs now and improving America's efficiency and productivity for tomorrow.



Fact Sheet

PROVIDING OPPORTUNITIES AND INCENTIVES FOR EMPLOYEES, ENTREPRENEURS AND FAMILIES

The President believes that a strong, growing, and dynamic economy increases opportunity for all Americans. The Administration's proposals support economic growth for the nation as a whole, while offering special incentives to address the concerns of employees, entrepreneurs and families.

A. Generating New Businesses and Jobs

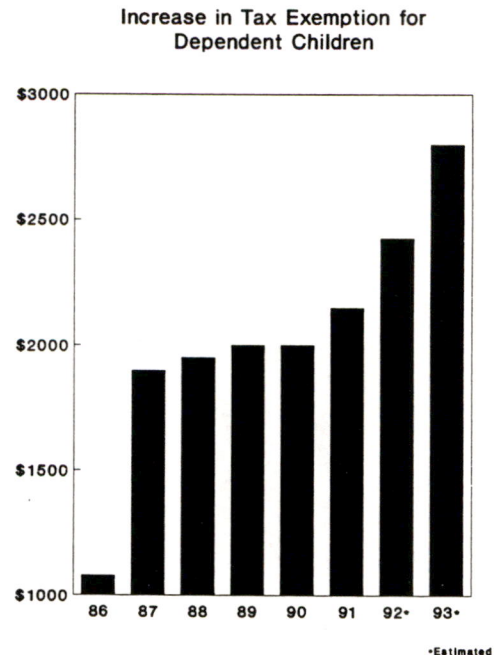
Administration policies will support the creation of jobs and increased prosperity for all Americans.

- o Investment incentives proposed by the President will increase employment in the short term through expanded investment activity, and in the long term, as a result of the improved physical capital put into place.
- o Capital gains tax rate reductions will stimulate entrepreneurial activity, generate jobs, and promote prosperity, by freeing up resources for families to reinvest.
- o Making the Research and Experimentations Tax Credit permanent will lead to innovation, increased competitiveness and productivity improvements that raise incomes and improve the quality of our lives.
- o Jobs for poor and disadvantaged Americans will be generated by the Administration's enterprise zone proposals and the Targeted Jobs Tax Credit. And extended unemployment benefits will help individuals and families who need extra time to find a job.
- o Employees in the boat-building and aviation industries will be helped by the Administration's proposal to repeal the excise tax imposed on boats and airplanes.

B. Sustaining Good Incomes

Policies to improve productivity and generate long-term economic growth offer the best hope for increasing family incomes and ensuring that America will successfully compete in the next century. In addition, Administration proposals address the special needs of low- and middle-income families.

- o Changing the tax withholding rules to more accurately reflect taxpayer liability will leave money in the hands of families and give them greater flexibility in managing their household budgets.
- o Permitting deduction of losses on personal homes will reduce the financial burden on many Americans who sell their homes in depressed markets because of a move to a new job or for family reasons.
- o The Low Income Housing Tax Credit will help to improve the availability of affordable housing for low-income rental households.
- o Families adopting children with special needs will be assisted by the Administration's proposal to extend the adoption tax credit.
- o Exclusion from income tax of subsidies to employees who use mass transportation will provide financial assistance to those employees who are most likely to need it, and will promote the use of public transportation.
- o Increasing the personal exemption by \$500 per child will help increase consumer purchasing power by giving families much-needed tax relief.

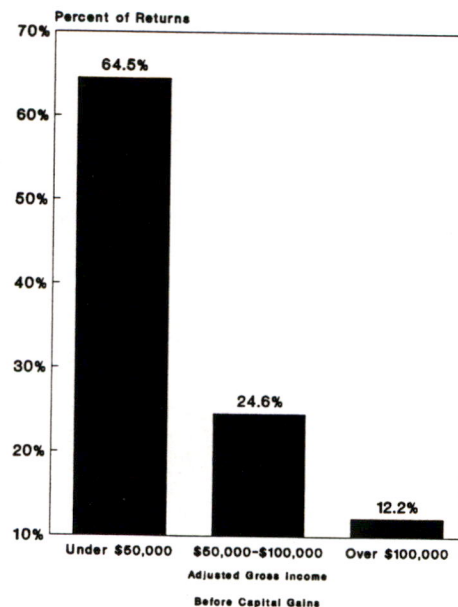


C. Building for the Future

The President is committed to high living standards for today and for our children. The Administration's proposals will ensure that the American dream will become a reality for future generations.

- o Continuing the commitment to pay-as-you-go budgeting will bring federal spending under control and help ensure a competitive America for our children.
- o Home ownership remains the cornerstone of the American dream and is the primary vehicle for most families to save and build for their future. The Administration's package of incentives for home ownership, combined with the lowest mortgage interest rates in nearly 20 years, will make now a great time for buying a home.

Who Reported Capital Gains in 1990



- o Capital gains tax rate reduction will open up opportunities for entrepreneurs to build up a family business; it also will increase the benefits of saving for the majority of Americans who either report capital gains during their lifetime or have a pension fund or retirement plan.
- o Other savings incentives, such as enhancing existing IRAs and creating new, Flexible IRAs, will help individuals and families achieve their long-term financial goals.
- o Allowing deduction of interest on student loans will improve the prospects for the millions of Americans who seek to expand their minds and opportunities by furthering their education, and it will help ensure that America has an educated work force that can compete with our trading partners.

General Explanations
of the
President's Budget Proposals
Affecting Receipts



Department of the Treasury
January 1992

SUMMARY OF PROPOSALS

The President's Budget contains tax proposals designed to create jobs, promote economic growth, assist families, and promote health, education, savings and home ownership. The tax proposals are divided into four categories: (1) Jobs and Investments; (2) Families, Health, Education and Savings; (3) Homebuyers; and (4) Other Proposals Affecting Receipts. These proposals are summarized below:

Jobs and Investments

- Enhance long-term investment by providing for the exclusion from income of up to 45 percent of long-term capital gains.
- Provide passive loss relief for real estate developers who materially participate in real estate development activity.
- Allow additional first-year depreciation of 15 percent of the cost of equipment acquired on or after February 15, 1992 and before January 1, 1993, and placed in service before July 1, 1993.
- Eliminate the depreciation component of the adjusted current earnings (ACE) adjustment for property placed in service on or after February 1, 1992.
- Make permanent the 20 percent credit for certain incremental research and experimentation (R&E) expenditures.
- Extend for an additional 18 months the rules for allocating research and experimental (R&E) expenditures between domestic and foreign source income.
- Extend the low-income housing tax credit for an additional 18 months.
- Extend the targeted jobs tax credit for an additional 18 months.
- Extend the business energy tax credits for an additional 18 months.
- Extend for an additional 18 months the authority of State and local governments to issue first-time farmer bonds.
- Establish enterprise zones.
- Modify the debt-financed income rules to facilitate investment in real estate by pension funds and qualified educational institutions.
- Repeal the luxury tax on aircraft and boats and, to offset the revenue loss, repeal the exemption from the existing excise tax on diesel fuel sold for use in motor boats.

Families, Health, Education and Savings

- Allow the deduction of interest on student loans for higher education or post-secondary vocational education.
- Establish flexible Individual Retirement Accounts (FIRAs) to which middle income taxpayers may make nondeductible contributions of up to \$2,500 per year, and from which contributions and earnings may be withdrawn without tax after 7 years.
- Promote retirement saving through a series of measures designed to encourage employers to sponsor retirement plans and simplify the taxation of pension distributions.
- Waive the 10 percent penalty on early withdrawals from IRAs if the money is used for medical or educational expenses of the owner or the owner's spouse or children.
- Extend for 18 months the deduction provided to self-employed individuals for 25 percent of the cost of health insurance coverage.
- Extend Medicare hospital insurance coverage to State and local governmental employees hired prior to April 1, 1986 who are not presently assured of Medicare coverage.
- Restore and double to \$3,000 the special needs adoption deduction.
- Increase to \$60, from its present \$21 level, the amount of employer-provided public transit pass expense that may be excluded from an employee's income.
- Increase the personal exemption for dependent children age 18 and under by \$500, effective October 1, 1992.

Homebuyers

- Provide first-time homebuyers a tax credit of up to \$5,000 (to be divided over 2 years) for purchases of first homes on or after February 1, 1992 and before January 1, 1993.
- Allow homeowners who sell their principal residences at a loss to claim a casualty loss deduction and, to the extent the casualty loss deduction is not allowed, roll the loss basis over into the basis of a new principal residence.
- Waive the 10 percent penalty on early withdrawals from IRAs for first-time home purchases.
- Extend for 18 months the authority for State and local governments to issue mortgage revenue bonds and mortgage credit certificates.

Other Proposals Affecting Receipts

- Continue support for revenue neutral tax Code simplification, including simplification of tax rules applying to individual taxpayers, relating to amortization of intangible assets, and governing payroll tax deposits for small- and medium-sized businesses.
- Revise the rules for charitable contributions by (1) making permanent the temporary alternative minimum tax exclusion for gifts of appreciated property and expanding it to all types of property; (2) treating all deductible charitable contributions as sourced to domestic income for foreign tax credit purposes; and (3) to offset the revenue loss from these changes, requiring charities to file annual information returns reporting contributions in excess of \$500.
- Conform book and tax accounting for securities dealers by requiring marketable securities to be included in inventory at their market value.
- Extend to all tax returns (including amended returns) the current provision that permits IRS not to pay interest on refunds claimed on original income tax returns if payment is made within 45 days.
- Disallow interest deductions of corporations for interest paid on loans secured by the cash value of life insurance policies covering their employees.
- Prohibit double dipping by thrift institutions by disallowing loss deductions that are reimbursed by excludable Federal financial assistance.
- Equalize the tax treatment of large credit unions and thrifts by repealing the tax exemption for credit unions with assets of \$50 million in any taxable year.
- Conform the treatment of annuities without substantial life contingencies to that of comparable investments by taxing income on the annuity investment as it is earned.
- Expand the communications excise tax to include communications via digital transmissions and coin-operated telephones.
- Make the orphan drug tax credit permanent.
- Adopt other receipts proposals.

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JOBS AND INVESTMENTS

ENHANCE LONG-TERM INVESTMENT: CAPITAL GAINS

The Budget again includes a reduction of the capital gains tax rate for individuals on long-term investments. The Budget provides for a 15, 30, or 45 percent exclusion for long-term capital gains on assets held by individual taxpayers for 1, 2, or 3 years, respectively. The 3-year holding period requirement will be phased in over 3 years.

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

Current Law

Under current law, the full amount of capital gains income is generally taxable but the rate on such gains is capped at 28 percent. Capital gains are generally subject to 15 percent or 28 percent statutory tax rates. However, the actual tax cost of an asset sale can be significantly higher when capital gains taxes interact with other tax provisions (for example, the floors on itemized deductions for medical and miscellaneous expenses and on itemized deductions generally, and the phase-outs for IRA deductions, passive activity loss limitations, and personal exemptions).

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 eligible for the 28 percent maximum rate and subject to the limitations on deduction of capital losses. Depreciation recapture rules recharacterize a portion of capital gains on depreciable property as ordinary income. These rules vary for different types of depreciable property.

Reasons for Change

Current high capital gains rates discourage savings, entrepreneurial activity, and high-risk investment in new products, processes, and industries. In the absence of a rate differential for long-term gains, investors are encouraged to focus on short-term earnings rather than on investments with longer-term growth potential. Our future competitiveness requires a sustained flow of capital to innovative, technologically-advanced activities that may generate minimal short-term earnings but promise strong future profitability. A preferential tax rate for longer-term commitments of capital encourages business investment patterns that favor innovation and growth over short-term profitability. The resulting increase in national output benefits all Americans by providing jobs and raising living standards. In addition to improving productivity and economic growth, lower rates on long-term capital gains improve the fairness of the individual income tax by providing a rough adjustment for taxing of inflationary gains that do not represent any increase in real income.

Incentives for Longer-Range Investment. A capital gains preference has long been recognized as an important incentive for capital investment. The first tax rate differential for capital gains was introduced by the Revenue Act of 1921. For the next 65 years, the tax laws provided a tax rate differential for long-term capital gains. This preferential treatment for capital gains has taken various forms, including an exclusion of a fixed portion of nominal gains, an exclusion that depended on the length of time a taxpayer held an asset, and a special maximum tax rate for capital gains. But at no time between 1921 and 1987 were long-term capital gains taxed at the same rates as ordinary income.

In 1990, Congress set the maximum statutory rate on capital gains at 28 percent, or 3 percentage points below the maximum statutory rate on ordinary income. Nevertheless, as shown in Figure 1, the average effective tax rate on realized capital gains is currently substantially higher than it has been in the past.

The 1986 Act increased the incentives for short-term trading of capital assets. This occurred because the Act increased the tax rate on long-term capital gains while reducing the tax rate on short-term capital gains. The Budget proposal would increase the incentive for longer term investment, by providing a sliding scale exclusion that, when fully phased in, provides full benefits only for investments held at least 3 years.

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

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

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

This lock-in effect of capital gains taxation has three adverse effects. First, it produces a misallocation of the nation's capital stock and entrepreneurial talent because it distorts the investment decisions that would be made in the absence of the capital gains tax. For example, the lock-in effect reduces the ability of entrepreneurs and investors to withdraw funds from an existing enterprise and use them to start new ventures. Productivity in the economy suffers because entrepreneurs are less likely to move capital to where it can be most productive, and because capital may be used less productively than if it were transferred to other, more efficient enterprises. These effects can be especially critical for smaller firms that are owner-operated and do not have good access to capital markets. Second, the lock-in effect produces distortions in the investment portfolios of individual taxpayers. For example, some individual investors may be induced to hold a different mix of assets than they desire because they are reluctant to sell appreciated investments to diversify their portfolios. Third, the lock-in effect reduces government receipts. To the extent that taxpayers defer sales of existing investments, or hold investments until death, taxes that might otherwise have been paid are deferred or avoided altogether.

Figure 1

Average Effective Tax Rate on Capital Gains, 1964-1989



Department of the Treasury
Office of Tax Policy
January 1992

Individual investors, the government, and other taxpayers lose from the lock-in effect. The investor is discouraged from pursuing more attractive investments and the government loses revenue, to the detriment of all taxpayers.

Substantial evidence from many respected studies demonstrates that high capital gains tax rates in previous years have produced significant lock-in effects. The importance of the lock-in effect may also be demonstrated by the fact that realized capital gains were 16 percent lower under the high tax rates in 1987 than under the lower rates in 1985, even though stock prices rose by approximately 50 percent over this period. The high tax rates on capital gains under current law imply that the lock-in effect is greater than at any prior time in our history.

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

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

There is evidence of a sharp decline between 1986 and the present in the amount of capital available to independent private venture capital funds, which have been one of the most valuable sources of capital for innovative but risky new firms. This decline correlates with the high capital gain tax rates introduced in 1986.

Double Tax on Corporate Stock Investment. Under the U.S. income tax system, income earned on investments in corporate stock is generally subjected to two layers of tax. Income on corporate investments is taxed first at the corporate level at a rate of 34 percent. Corporate income is taxed a second time at the individual level in the form of taxes on capital gains and dividends, at rates ranging from 15 to 31 percent. The combination of corporate and individual income taxes can thus produce effective tax rates that are substantially higher than individual income tax rates alone. To the extent an investor's return is obtained through appreciation in the value of stock (rather than through dividend income), a reduction in capital gains tax rates provides a form of relief from this double taxation of corporate income. While a lower capital gains tax rate reduces the cost of capital for both corporate and noncorporate business, the greater liquidity of shares in publicly-traded companies suggests that the overall effect would be to reduce the bias towards noncorporate business that results from our dual-level tax system.

Proposal

General Rule. The capital gains tax rate would be reduced by means of a sliding-scale exclusion. Individuals would be allowed to exclude a percentage of the capital gain realized upon the disposition of qualified capital assets, and would apply their current statutory rate on capital gains (either 15 or 28 percent) to the reduced amount of taxable gain. The amount of the exclusion would depend on the holding period of the assets. Assets held more than 3 years would qualify for an exclusion of 45 percent. Assets held more than 2 years but not more than 3 years would qualify for a 30 percent exclusion. Assets held more than 1 year but not more than 2 years would qualify for a 15 percent exclusion. For example, individuals subject to a 28 percent tax on capital gains would pay rates of 23.8, 19.6, and 15.4 percent for assets held 1, 2, or 3 years, respectively. The corresponding figures for individuals subject to a 15 percent rate would be 12.8, 10.5, and 8.3 percent.

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

Phase-in Rules and Effective Dates. The proposal would be effective generally for dispositions of qualified assets after the date of enactment. For the balance of 1992, the full 45 percent exclusion would apply to assets held more than 1 year. For dispositions of assets in 1993, assets would be required to have been held for more than 2 years to be eligible for the 45 percent exclusion, and more than 1 year to be eligible for the 30 percent exclusion. For dispositions of assets in 1994 and thereafter, assets would be required to have been held more than 3 years to be eligible for the 45 percent exclusion, more than 2 years to be eligible for the 30 percent exclusion, and more than 1 year for the 15 percent exclusion.

Additional Provisions. In order to prevent taxpayers from benefitting from the exclusion provision for depreciation deductions that have already been claimed in prior years, the existing depreciation recapture rules would be expanded to recapture all prior depreciation deductions. All taxpayers would be able to benefit from the proposed exclusion only to the extent that a depreciable asset has increased in value above its unadjusted basis. Absent such a provision, a taxpayer could claim depreciation deductions against income taxable at, for example, a 31 percent marginal rate, yet pay tax on the restoration of those deductions when the asset is sold at 15.4 percent even though there was no increase in the value of the asset over its initial purchase price. The excluded portion of capital gains would be added back when calculating income under the alternative minimum tax. Installment sale payments received after the effective date will be eligible for the exclusion without regard to the date the sale actually took place. For purposes of the investment interest limitation, only the net capital gain after subtracting the excluded amount would be included in investment income. The 28 percent limitation on capital gains not eligible for the exclusion would be retained.

Effects of Proposal

Example A. Taxpayer A is a single individual earning \$16,000 whose mutual fund investments have a reported long-term capital gain of \$500 in late 1992.

Under current law, her tax on the \$500 capital gain would be 15 percent of the full \$500 gain, or \$75.

Under the proposal, her tax would be reduced to \$41.25, which is 15 percent of \$275 (\$500 less the 45 percent exclusion).

Example B. Couple B is a two-earner couple with combined taxable income other than capital gains of \$50,000. In 1994, they sell corporate stock realizing a \$1,500 capital gain on stock held 15 months and a \$2,500 capital gain on stock held 5 years.

Under current law both gains would be taxed at a rate of 28 percent. Tax on the \$1,500 gain would be \$420, and tax on the \$2,500 gain would be \$700, for a combined tax of \$1,120.

Under the proposal, the gain on the stock held 15 months would be eligible for a 15 percent exclusion and the gain on the stock held 5 years would be eligible for a 45 percent exclusion. The tax on the stock held 15 months would be \$357 and the tax on the stock held 5 years would be \$385, for a combined tax of \$742, which would be 34 percent lower than Couple B's liability under current law.

Example C. Taxpayer C is the founder of a 5-year old computer software company and would like to sell the company in order to start a new company making a new product. Taxpayer C has a salary of \$380,000 and \$20,000 in dividend and interest income. Taxpayer C sells the stock in the computer software company for \$2 million, resulting in a capital gain of \$1.8 million after deduction of his \$200,000 cost basis.

Under current law, taxpayer C would pay a capital gains tax of about \$520,740 (depending on the level and composition of his itemized deductions), leaving him with net proceeds of \$1,479,260 from the sale of the company.

Under the proposal, the capital gains tax, including the alternative minimum tax, would be about \$436,455 (again, depending on the level and composition of his itemized deductions). The net proceeds from selling the company would be about \$1,563,545. Thus, Taxpayer C would have about \$84,285 of additional funds that could be invested in the new business.

Distributional Effects of Proposal. A capital gains tax reduction is likely to benefit taxpayers at all income levels. High-income taxpayers will be better off because of the lower capital gains tax rates, even though some of them will actually pay more in taxes because of additional realizations induced by the exclusion. Lower and middle-income taxpayers will also be better off because of lower taxes on the capital gains they realize. All taxpayers will benefit from the enhanced economic productivity and growth which results from a reduction in capital gains tax rates. The benefit to the U.S. economy is the most important issue with respect to a capital gains tax reduction, and this benefit is shared by all.

Revenue Estimate

Capital gains realizations are highly responsive to changes in stock prices and general economic conditions as well as to capital gains tax rates. Furthermore, taxpayers may adjust their purchases and sales of capital assets and their income sources and deductions in response to new tax rules. Since 1978, Treasury revenue estimates of capital gains have taken into account expected changes in taxpayer behavior.

These behavioral effects are the subject of continued empirical research. Treasury's Office of Tax Analysis (OTA) incorporates unlocking effects and all other behavioral effects believed to be important and presents its best estimate of the expected effects. In accordance with revenue estimating convention, the estimates do not take into account additional revenues anticipated by reason of increases in the gross domestic product. The proposal is expected to increase Treasury receipts as compared to current law receipts due to increased realizations. The revenue estimates noted below assume a February 1, 1992 effective date. The increase in revenues is expected to be greatest in fiscal year 1993, due to the unlocking of existing capital gains, and smaller thereafter. The expected changes in revenues are modest in comparison to the magnitude of the expected total amount of revenues from the capital gains tax (in excess of \$30 billion per year).

Details of Revenue Estimate. The details of the revenue estimate are shown in Table I. Line 1 of Table 1 shows the revenue loss that results from a flat 45 percent exclusion of the amount of capital gains that would be realized at current law tax rates; i.e., "baseline" realizations that would have occurred without a change in tax rates. This loss is what a "static" revenue estimate for a 45 percent exclusion would show. This "static" revenue loss is estimated to be \$16.3 billion in fiscal year 1993, gradually increasing to about \$22 billion by 1997.

Line II of Table 1 shows the estimated revenue from additional realizations that would be induced by a flat 45 percent exclusion. These induced gains arise from several sources. They represent realizations accelerated from future years, realizations due to portfolio shifting, or realizations that would otherwise have been tax-exempt because they would have been held until death, donated to charity, or not reported. As indicated by a comparison of line I and II, revenues from induced realizations are estimated to be sufficient to offset the static revenue loss on current gains for several years, but not in the long run. This conclusion is based on Treasury's analysis of the findings of numerous statistical studies of the responsiveness of capital gains to lower tax rates, and is consistent with the revenue experience of previous capital gains tax rate changes.

Line III shows the revenue effects of limiting the exclusion to 30 percent for assets held 2 years and 15 percent for assets held 1 year, and the phase-in of these holding period limitations. The estimates reflect the net effect of the reduction in static revenue losses, and the deferral of realizations of assets not yet qualifying for the full 45 percent exclusion. These provisions, which are aimed at promoting a longer-term investment horizon, produce a net revenue gain over the budget period.

Table 1
Revenue Effects of the President's Capital Gains Proposal

Item	Fiscal Years (\$ Billions)						
	1992	1993	1994	1995	1996	1997	1992-97
I. Static effect of 45 percent exclusion	-2.4	-16.3	-17.9	-19.5	-21.0	-22.5	-99.5
II. Effect of 45 percent exclusion on taxpayer behavior	2.9	19.2	18.3	17.0	16.6	17.2	91.1
III. Effect of reducing exclusion to 15 percent and 30 percent for assets held one and two years ¹	0.0	-0.1	-0.7	-0.5	1.1	1.2	1.0
IV. Effect of treating excluded gains as a preference item for AMT purposes	0.1	0.7	1.4	2.0	2.2	2.5	8.9
V. Effect of depreciation recapture	0.0	0.3	1.0	1.2	1.3	1.4	5.4
VI. Total revenue effect of proposal	0.6	3.8	2.1	0.3	0.3	-0.2	6.9

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Note: Details may not add to total due to rounding.

¹ Assets held 1 to 2 years receive an exclusion of 30 percent in 1993. Beginning in 1994, an exclusion of 15 percent is accorded assets held 1 to 2 years and 30 percent for assets held 2 to 3 years. Note that the estimates, along with those in lines IV and V, reflect both static and behavioral effects.

Lines IV and V show the revenue effects of treating excluded capital gains as a preference item for purposes of the alternative minimum tax and expanded depreciation recapture. Over the budget period, these two provisions raise \$14.3 billion in revenue. The full depreciation recapture proposal means that if a depreciable asset is sold, the exclusion will apply only to the amount by which the current selling price is higher than the original cost. Treating excluded gains as a preference item for purposes of the alternative minimum tax primarily affects high-income individuals and raises \$8.9 billion over the budget period. The total revenue effect of the proposal is shown in line VI. The proposal is expected to raise revenue in every year except 1997, and \$6.9 billion over the budget period.

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

PROVIDE PASSIVE LOSS RELIEF FOR REAL ESTATE

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 1986 Act, 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, a taxpayer's operations must be organized into activities that are either trade or business activities or rental activities. If a taxpayer conducts more than one trade or business operation in the same line of business, those operations may be treated as one activity. Income and losses from all operations included in a single activity are taken into account in determining the income or loss from the activity for any taxable year. In general, rental operations may not be treated as part of a trade or business activity.¹ Thus, an individual engaged in a real estate development business that derives 60 percent of his gross income from the construction of property and 40 percent of his gross income from the rental of property would be engaged in two activities (one trade or business and one rental) rather than one, notwithstanding the fact that the operations may be conducted as part of an integrated business.

Income or loss from a trade or business activity is passive unless the taxpayer materially participates in the activity. 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. A taxpayer's participation in an activity is determined by taking the sum of the number of hours the taxpayer participates in each of the operations that are included with the activity.

In the case of rental activities, income and losses 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. Under a limited exception to the rental rule, a taxpayer with modified adjusted gross income not greater than \$100,000 may treat up to \$25,000 of real estate rental losses as nonpassive if the taxpayer actively participates in the rental activities for the taxable year. Active participation is a lesser standard of involvement than material participation and generally requires that the taxpayer participate in making management decisions or arrange for others to provide services such as repairs in a significant and bona fide sense. A taxpayer is generally deemed not to satisfy the active participation standard with respect to property he holds through a limited partnership interest. The \$25,000 amount begins to phase out for taxpayers with modified adjusted gross income over \$100,000 and is completely phased out when a taxpayer's modified adjusted gross income reaches \$150,000. This exception applies only to the losses from the rental of real property in which the taxpayer holds at least a 10 percent interest.

¹An exception to this rule is made when one of the operations (either rental or trade or business) generates more than 80 percent of the total gross income of the combined operations.

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 consists of real estate development may materially participate in a variety of endeavors, including the management, renovation, construction, ownership and rental of real estate. Nevertheless, losses arising from the rental of real property the taxpayer has developed may not be used to offset income from the taxpayer's nonrental real estate operations that are part of the same real estate development business except to the extent of the limited exception described above. As a result, taxpayers who develop real property for rental are required to treat what is a single integrated business as two separate activities, one active and one passive. The separation of these activities may result in income distortions.

Proposal

The passive loss rules would be amended to permit taxpayers to treat their real estate development operations as a single trade or business activity. Real estate development activity would include real estate development operations (as defined below) in which the taxpayer actively participates. Income and loss from this activity would be nonpassive if the taxpayer materially participates in the activity. Real estate development operations would be defined as (1) the construction, substantial renovation and management of real property, regardless of whether the taxpayer holds an interest in the property; (2) the lease-up and sale of real property in which the taxpayer has at least a 10-percent ownership interest; and (3) the rental of property that was developed by the taxpayer. Property would be treated as having been developed by the taxpayer only if the taxpayer materially participated in the construction or substantial renovation of the property. No operations would be included in the real estate development activity unless the taxpayer meets the active participation standard with respect to the operations. The proposed amendment would be effective for taxable years ending on or after December 31, 1992.

Effects of Proposal

The proposal would permit taxpayers who actively participate in the rental of the properties they develop to offset their rental losses against income from other real estate development operations in which they actively participate, as well as income not related to real estate development operations. This relaxation of the passive loss rules will ease the income distortions affecting taxpayers who develop real property for rental. At the same time, this modification will not undermine the important purpose of the passive loss rules, *i.e.*, to curb tax shelters. The provision is limited to rental losses from properties the taxpayer has developed and is therefore targeted to those taxpayers in the best position to make investments based on economic rather than tax considerations.

Revenue Estimate

	Fiscal Years						<u>1992-97</u>
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	
			(Billions of Dollars)				
Provide passive loss relief for real estate:	-0.1	-0.4	-0.4	-0.4	-0.5	-0.6	-2.5

ADOPT INVESTMENT TAX ALLOWANCE (ITA)

Current Law

Current law generally permits purchasers of tangible property that is used in a trade or business or held for the production of income to recover the cost of the property by taking annual tax deductions during the property's useful life. Certain types of property (for example, inventories) are not depreciable.

In the case of property placed in service after 1986, the Modified Accelerated Cost Recovery System (MACRS) applies in determining the amount of depreciation allowable in any particular taxable year. MACRS specifies the period over which the cost of property can be recovered, the method to be used to determine the amount of depreciation allowable, and the conventions (or placed-in-service-date assumptions) to be used in determining depreciation.

Equipment that is depreciable under MACRS generally has a recovery period of 3, 5, 7, or 10 years. The cost of property in these classes is generally recovered using the 200 percent declining-balance method over the established MACRS recovery periods. Owners of property in these classes may, however, elect to recover costs using a 150 percent declining-balance method over class lives that are somewhat longer than the regular recovery periods. Alternatively, owners of property in these classes may elect to use straight-line depreciation over either the regular recovery periods or the longer class lives. Current law provides tables for calculating depreciation deductions under each of these methods.

In addition, averaging conventions are used to determine placed-in-service dates for depreciation calculations. For example, under the half-year convention, which generally applies to property placed in service in any particular taxable year, the property is treated as placed in service in the middle of the purchaser's taxable year. Accordingly, only half of a year's depreciation is allowable in that year, and half of a year's depreciation is allowable in the taxable year in which the recovery period ends.

There are certain alternative minimum tax adjustments with respect to depreciation. In determining alternative minimum taxable income, taxpayers must generally calculate depreciation using the 150 percent declining-balance method over the property's class life. During the earlier years of a property's recovery period, this results in a deduction for alternative minimum tax purposes smaller than that allowed for regular tax purposes using the 200 percent declining-balance method over the property's regular recovery period. In addition, corporate taxpayers must compute adjusted current earnings for alternative minimum tax purposes using the straight-line method over the property's class life. Corporate taxpayers generally must increase alternative minimum taxable income to reflect an adjustment based on adjusted current earnings.

Current law also provides for recognition of ordinary gain on disposition of certain depreciable property. This provision is contained in section 1245 of the Internal Revenue Code, and the property to which the provision applies is defined as "section 1245 property." Section 1245 property generally includes depreciable or amortizable tangible personal property used in a trade or business or held for investment, and other depreciable or amortizable tangible property used in manufacturing or production operations, in research facilities, or in producing energy or furnishing services such as communications

or transportation services. Section 1245 property generally does not include real property, such as buildings or their structural components.

Reasons for Change

A temporary acceleration of depreciation deductions would accelerate purchases of new equipment, thus promoting capital investment, modernization, and a more rapid economic recovery.

Proposal

Under the proposal, an investment tax allowance (ITA) would be available for new equipment acquired on or after February 1, 1992, and before January 1, 1993, if the equipment is placed in service before July 1, 1993. The ITA would equal 15 percent of the purchase price of the equipment. The ITA would be taken in the taxable year the equipment is placed in service, and would reduce the tax basis of the equipment for purposes of calculating depreciation in the year the equipment is placed in service and in subsequent years and for purposes of determining gain or loss on disposition.

For example, assume that on March 15, 1992, a calendar-year corporate taxpayer purchased \$1,000,000 of equipment with a 5-year recovery period and a 6-year class life, and the equipment was eligible for the 15 percent ITA under the proposal. The taxpayer would be allowed an ITA of \$150,000 for 1992, would adjust its basis in the equipment to \$850,000, and would calculate the otherwise allowable deduction for 1992 using the \$850,000 adjusted basis (and the half-year convention). If the taxpayer used the 200 percent declining-balance method over the 5-year MACRS recovery period, the 1992 depreciation deductions would total \$320,000 (\$150,000 plus \$170,000); if the taxpayer used the 150 percent declining-balance method over the 6-year class life, the 1992 depreciation deductions would total \$256,250 (\$150,000 plus \$106,250); and if the taxpayer elected the straight-line method over the regular recovery period, the 1992 depreciation deductions would total \$235,000 (\$150,000 plus \$85,000).

The alternative minimum tax adjustments for depreciation would not apply to the 15 percent ITA provided under the proposal. Thus, in the above example, the taxpayer would be allowed a \$320,000 deduction for regular tax purposes and a \$256,250 deduction for alternative minimum tax purposes.

The 15-percent ITA would also be permitted in calculating adjusted current earnings. Under the Administration's proposal to eliminate the adjustment for depreciation in computing adjusted current earnings with respect to property placed in service on or after February 1, 1992, the depreciation deduction allowable in computing adjusted current earnings would equal the \$256,250 deduction allowable for alternative minimum tax purposes.

All section 1245 property would benefit from the ITA. Thus, equipment would include any depreciable or amortizable tangible personal property used in a trade or business or held for investment, such as machinery, a computer, a lathe, or a printing press. Equipment would also include depreciable or amortizable tangible property that is not personal property but is section 1245 property, such as a broadcast tower, a livestock fence, or a wind tunnel in a research facility. Equipment would not include intangibles such as patents or computer software, and generally would not include buildings or structural components of buildings.

In general, equipment would be considered acquired on the date the taxpayer obtains, or enters into a binding contract to obtain, the equipment. Equipment constructed or manufactured by the taxpayer for the taxpayer's own use would be eligible for the ITA if the construction or manufacture began on or after February 1, 1992, and before January 1, 1993, and if the equipment was placed in service before July 1, 1993. The date on which equipment is placed in service would be determined under the generally applicable depreciation rules.

The proposal is intended to accelerate investment in new equipment. Thus, if a binding contract to acquire equipment was in effect before February 1, 1992, the equipment would not be eligible for the ITA.

The gain recognition rules of section 1245 would apply on disposition of equipment on which the ITA has been allowed.

Effects of Proposal

The proposal would reduce the cost of capital and increase business cash flow, thus providing a temporary incentive to increase investment. Because the additional depreciation would be available only for equipment acquired during the remainder of 1992, the stimulus to investment during 1992 would be maximized.

Revenue Estimate

	Fiscal Years						
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1992-97</u>
	(Billions of Dollars)						
Adopt investment tax allowance:	-6.1	-1.6	3.5	0.9	0.8	0.6	-1.7

SIMPLIFY AND ENHANCE ALTERNATIVE MINIMUM TAX DEPRECIATION

Current Law

Under current law, a corporation is subject to an alternative minimum tax (AMT) which is payable to the extent that the corporation's tentative minimum tax exceeds its regular income tax liability. The tentative minimum tax generally equals 20 percent of the corporation's alternative minimum taxable income. Alternative minimum taxable income is the corporation's taxable income increased by its tax preferences and adjusted by redetermining its tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those 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 permitted under MACRS in arriving at taxable income. If a corporation 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 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 corporation's regular income tax liability exceeds its tentative minimum tax in a particular taxable year, the corporation 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. For AMT paid in a taxable year beginning on or after January 1, 1990, a corporation is entitled to a minimum tax credit equaling its entire AMT liability.

Reasons for Change

There is general concern that the depreciation component of the ACE adjustment causes a disincentive to capital investment for U.S. corporations. As a result of the depreciation adjustment required in computing ACE, many capital-intensive corporations are subject to the AMT. The effects of the adjustment are magnified for capital-intensive corporations that are growing or showing depressed earnings. Because many such corporations may find themselves continually subject to the AMT, the minimum tax credit is of little value in mitigating the long-term effects of the ACE depreciation adjustment.

The ACE depreciation adjustment is also the source of substantial complexity. As a result of the adjustment, corporations must make three separate depreciation computations to determine taxable income and alternative minimum taxable income.

Proposal

Effective for property placed in service on or after February 1, 1992, the depreciation component of the ACE adjustment would not apply. The general requirement that a corporation use the 150 percent declining-balance depreciation method over the class life of the property would continue to apply, however, for purposes of computing alternative minimum taxable income. In computing ACE, the corporation would compute depreciation for this property using the same methods and recovery periods that it uses in computing alternative minimum taxable income.

Effects of Proposal

The proposal would (1) target the reduction in the AMT on new investments in depreciable property, without providing a windfall for prior investments, (2) simplify the AMT by requiring only one computation of depreciation for AMT purposes, and (3) generally provide a more appropriate ACE depreciation method than straight-line.

Revenue Estimate

	<u>1992</u>	<u>1993</u>	<u>Fiscal Years</u>				
			<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1992-97</u>
			(Billions of Dollars)				
Simplify and enhance AMT depreciation:	-0.2	-0.4	-0.4	-0.3	-0.2	-0.1	-1.5

EXTEND RESEARCH AND EXPERIMENTATION (R&E) TAX CREDIT

Current Law

Current law allows a 20 percent tax credit for a certain portion of a taxpayer's "qualified research expenses." The portion of qualified research expenses that is eligible for the credit is the increase in the current year's qualified research expenses over its base amount for that year. The base amount for the current year is computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the 4 preceding years. A taxpayer's fixed-base percentage generally is the ratio of its total qualified research expenses for the 1984-88 period to its total gross receipts for this period. Special rules for start-up companies provide a fixed-base percentage of 3 percent. In no event will a taxpayer's fixed-base percentage exceed 16 percent. A taxpayer's base amount may not be less than 50 percent of its qualified research expenditures for the current year.

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

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

Current law also provides a separate 20 percent tax credit ("the university basic research credit") for corporate funding of basic research through grants to universities and other qualified organizations performing basic research. The university basic research credit is measured by the increase in spending from certain prior years. This basic research credit applies to the excess of (1) 100 percent of corporate cash expenditures (including grants or contributions) paid for university basic research over (2) the sum of a fixed research floor plus an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed based period (adjusted for inflation). A grant is tested first to see if it constitutes a basic research payment; if not, it may be tested as a qualified research expenditure under the general R&E credit.

The R&E credit is aggregated with certain other business credits and made subject to a limitation based on tax liability. The sum of these credits may reduce the first \$25,000 of regular tax liability without limitation, but may offset only 75 percent of any additional tax liability. Taxpayers may carry credits not usable in the current year back 3 years and forward 15 years.

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

The R&E credit in the form described above is in effect for taxable years beginning after December 31, 1989. However, the credit will not apply to amounts paid or incurred after June 30, 1992.

Reasons for Change

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

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

Proposal

The R&E credit would be made permanent.

Effects of Proposal

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

Revenue Estimate

	Fiscal Years						
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1992-97</u>
	(Billions of Dollars)						
Extend R&E credit:	-0.2	-0.8	-1.4	-1.6	-1.8	-2.1	-7.8

EXTEND RESEARCH AND EXPERIMENTAL (R&E) ALLOCATION RULES

Current Law

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

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

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

Since 1981 these R&E allocation regulations have been subject to seven different suspensions and temporary modifications by Congress. The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) adopted allocation rules which were in effect for only 4 months. For 20 months following the period when the TAMRA rules were in effect, R&E allocation was controlled by the 1977 Treasury regulations. The Budget Reconciliation Act of 1989 subsequently reintroduced the TAMRA rules, once again on a temporary basis. These rules were extended to taxable years beginning on or before August 1, 1991 by the Omnibus Budget Reconciliation Act of 1990, and were further extended to the first 6 months of the first taxable year beginning on or after August 1, 1991 by the Tax Extension Act of 1991.

Under the R&E allocation rules enacted by TAMRA (and temporarily extended in 1989, 1990 and 1991), a taxpayer must allocate 64 percent of R&E expenses for research conducted in the United States to U.S. source income and 64 percent of foreign-performed R&E expenses to foreign source income. The remaining portion can be allocated on the basis of the taxpayer's gross sales or gross income. However, the amount allocated to foreign source income on the basis of gross income must be at least 30 percent of the amount allocated to foreign source income on the basis of gross sales.

Reasons for Change

The Administration believes providing tax incentives to increase the performance of U.S.-based research activities. The allocation rules in this proposal provide such an incentive. Although the proposal benefits only multinational corporations that are subject to the foreign tax credit limitation, it will provide an incentive with respect to such entities. By enhancing the return on R&E expenditures, the proposal encourages the growth of overall R&E activity as well as the location of such research within the United States.

Proposal

The proposal would provide an 18-month extension of the R&E allocation rules.

Effects of Proposal

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

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

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

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

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

Revenue Estimate

	Fiscal Years						
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1992-97</u>
			(Billions of Dollars)				
Extend R&E allocations rules:	-0.2	-0.5	-0.3	0.0	0.0	0.0	-0.9

EXTEND LOW-INCOME HOUSING TAX CREDIT

Current Law

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

The discounted present value of the installments of the credit is generally 70 percent of the depreciable costs of new construction and substantial rehabilitations, and 30 percent of the cost of acquiring existing buildings which have been substantially rehabilitated (so long as they have not been placed in service within the previous 10 years and are not already subject to a 15-year compliance period). The basis of property is not reduced by the amount of the credit for purposes of calculating depreciation and capital gain.

The annual credit available for a building cannot exceed the amount allocated to the building by the designated State or local housing agency. A State credit allocation is not required, however, for certain projects financed with tax-exempt bonds subject to the State's private activity bond volume limitation.

The low-income housing tax credit was enacted as part of the Tax Reform Act of 1986. Originally, it provided States with the authority to allocate credits for 1987 to 1989 in annual amounts equal to \$1.25 per State resident. The Omnibus Budget Reconciliation Act of 1989 extended each State's allocation authority through 1990, but at a reduced annual level of \$0.9375 per State resident. The Omnibus Budget Reconciliation Act of 1990, however, increased the allocation authority for 1990 to \$1.25 per State resident and extended allocation authority through 1991 at the same annual level. The Tax Extension Act of 1991 extended each State's allocation authority until June 30, 1992, at the level of \$1.25 per State resident.

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 rental households. A study for the Department of Housing and Urban Development that was completed in February 1991 concluded that roughly 128,000 tax credit units were completed during 1987 and 1988, the first 2 years of the program, and that the families occupying these units typically had an income well below the allowable program maximum (60 percent of area median family income).

Proposal

The proposal would extend the authority of States to allocate the credit through December 31, 1993, at the level of \$1.25 per State resident.

Effects of Proposal

Extending the low-income housing tax credit would encourage the private sector to continue to construct and rehabilitate housing and to make it available to low-income families.

Revenue Estimate

	Fiscal Years						
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1992-97</u>
	(Billions of Dollars)						
Extend low-income housing tax credit:	-*	-0.2	-0.3	-0.4	-0.4	-0.4	-1.7

* Less than \$50 million.

EXTEND TARGETED JOBS TAX CREDIT

Current Law

The targeted jobs tax credit is available 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 former 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 was scheduled to expire December 31, 1991, but was extended by the Tax Extension Act of 1991 through June 30, 1992. Accordingly, the credit is available with respect to targeted-group individuals who begin work for the employer on or before 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. Job creation incentives are required in the current economic climate.

Proposal

The targeted jobs tax credit would be extended for 18 months. The credit would be available with respect to targeted-group individuals who begin work for the employer on or before December 31, 1993.

Revenue Estimate

	Fiscal Years						
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1992-97</u>
	(Billions of Dollars)						
Extend targeted jobs tax credit:	-0.1	-0.2	-0.2	-0.1	-*	-*	-0.5

* Less than \$50 million.

EXTEND BUSINESS ENERGY TAX CREDIT

Current Law

A tax credit is allowed for investment in solar or geothermal energy property. The amount of the credit is 10 percent of the investment. Solar property is equipment that uses solar energy to generate electricity or steam or to provide heating, cooling, or hot water in a structure. Geothermal property consists of equipment, such as a turbine or generator, that converts the internal heat of the earth into electrical energy or another form of useful energy. The credits for solar and geothermal property have been scheduled for expiration a number of times in recent years, but have been extended each time, most recently by the Tax Extension Act of 1991, which extended the credits through June 30, 1992.

Reasons for Change

The geothermal and solar credits are intended to encourage investment in renewable energy technologies. Increased use of solar and geothermal energy would reduce our nation's reliance on imported oil and other fossil fuels and would improve our long-term energy security. Use of geothermal and solar energy resources also reduces air pollution.

Proposal

The solar and geothermal credits would be extended for 18 months to December 31, 1993.

Revenue Estimate

	Fiscal Years						
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1992-97</u>
	(Billions of Dollars)						
Extend business energy tax credits:	_*	_*	_*	_*	*	*	-0.1

* Less than \$50 million.

EXTEND FIRST-TIME FARMER BONDS

Current Law

State and local governments may use the proceeds of tax-exempt bonds to make loans to private individuals or entities for the purpose of acquiring or constructing manufacturing facilities or to make loans to certain first-time farmers for the purpose of acquiring farmland and equipment. Tax-exempt bonds used for these purposes are authorized under the Internal Revenue Code as qualified small issue bonds.

Only individuals or entities with relatively small capital investments (i.e., less than \$1 million in some cases and less than \$10 million in other cases) in the jurisdiction of the issuer of the bonds are eligible to use qualified small issue bonds for manufacturing facilities. Proceeds of qualified small issue bonds loaned to first-time farmers may not exceed \$250,000 per farmer and may be used only to acquire qualifying farmland and certain farm-related depreciable property.

Qualified small issue bonds are subject to the tax-exempt bond volume cap and must compete with other private activity bonds for a share of a State's volume cap. The authority to issue qualified small issue bonds was scheduled to expire December 31, 1991. This authority was extended through June 30, 1992 by the Tax Extension Act of 1991.

Reasons for Change

The provision of a modest amount of low-interest rate financing to first-time farmers through qualified small issue bonds is intended to encourage new individuals to become farmers. There has been a steady reduction in the number of smaller "family farms" in operation and fewer new individuals are entering into the smaller-scale farming business.

Proposal

Those portions of section 144 of the Code which provide the authority to issue qualified small issue bonds for first-time farmers would be extended 18 months, to December 31, 1993.

Effects of Proposal

The availability of low-interest rate financing should encourage new individuals to engage in the business of small-scale farming. Lower costs of borrowing to these individuals should help make them become more competitive and improve profitability of small farming operations.

Revenue Estimate

	Fiscal Years						
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1992-97</u>
	(Billions of Dollars)						
Extend first-time farmer bonds:	_*	_*	_*	_*	_*	_*	_*

* Less than \$50 million.

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

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

Reasons for Change

To help economically distressed areas share in the benefits of economic growth, the Administration proposes to designate Federal enterprise zones which will benefit from targeted tax incentives and regulatory relief. The tax incentives and regulatory relief provided by this proposal will stimulate government and private sector revitalization of the areas.

Proposal

The proposed enterprise zone initiative would include selected Federal income tax employment and investment incentives. These incentives would be offered beginning in 1993 in conjunction with Federal, State, and local regulatory relief. Up to 50 zones would be selected over a 4-year period.

The incentives are: (1) a 5 percent refundable tax credit for qualified employees with respect to their first \$10,500 of wages earned in an enterprise zone (up to \$525 per worker, with the credit phasing out when the worker earns between \$20,000 and \$25,000 of total annual wages); (2) elimination of capital gains taxes for tangible property located within an enterprise zone and used in an enterprise zone business for at least 2 years; and (3) expensing by individuals of contributions to the capital of corporations engaged in the conduct of enterprise zone businesses (provided the corporation does not have more than \$5 million of total assets and uses the contributions to acquire tangible assets located within an enterprise zone, and with the expensing limited to \$50,000 annually per investor with a \$250,000 lifetime limit per investor).

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

Effects of Proposal

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

Revenue Estimate

	<u>1992</u>	<u>1993</u>	<u>Fiscal Years</u>				
			<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1992-97</u>
			(Billions of Dollars)				
Establish enterprise zones:	-	-*	-0.2	-0.3	-0.5	-0.8	-1.8

*Less than \$50 million.

FACILITATE 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. The debt-financed income rules do not apply, however, to certain investments in real estate by qualified pension or profit sharing trusts ("qualified trusts") and certain educational organizations that provide instruction to enrolled students ("educational institutions").

The following requirements must be satisfied in order for a direct investment in real property by a qualified trust or educational institution to be excepted from the debt-financed income rules: (1) the price of the real property must be a fixed amount determined as of the date the investment is acquired; (2) the amount of (or any amount payable with respect to) any indebtedness, or the time for making payment of any such amount, must not be dependent, in whole or in part, upon any revenue, income, or profits derived from the real property; (3) the real property must not, at any time after the acquisition, be leased to the person who sold the property to the qualified trust or educational institution, or to a person related to such person; (4) in the case of a qualified trust, the real property must not be acquired from a person related to any plan with respect to which the trust was formed; and (5) the seller of the real property (or a person related to the plan with respect to which a qualified trust was formed) must not provide the qualified trust or educational institution with financing in connection with the acquisition of the property. (These are collectively referred to as the sale-leaseback rules.)

The requirements described above were intended to prevent abusive transactions in which a business was sold to a tax-exempt entity on the installment basis (i.e., with seller financing) and then leased back to the seller, often with both the purchase price and the rents contingent on profits from the business. The seller deducted the profits from the business as they were paid to the exempt organization in the form of rent and then reported them as capital gain when the exempt organization paid them back in the form of installment payments on the purchase of the business.

Under a separate statute, all tax-exempt organizations are subject to UBIT on income they earn (whether or not debt-financed or unrelated) through publicly traded partnerships that are not otherwise treated as corporations for tax purposes. These types of publicly traded partnerships include those engaged in real estate investment activities.

Reasons for Change

If any of the elements described above are present, a debt-financed investment in real estate will not qualify for exception from taxation as debt-financed income under the sale-leaseback rules even where the transaction is not abusive. Modifications to the debt-financed income rules are necessary to permit qualified trusts and educational institutions to make debt-financed investments in real property on commercially reasonable terms in circumstances where there is no potential for abuse. In addition, there is no compelling reason to subject a non-leveraged investment in a publicly traded partnership to UBIT where a direct investment (or an investment in a non-publicly traded partnership) engaged in the same activity could be conducted free of tax.

Proposal

1. General exceptions.

De minimis exception to sale-leaseback prohibition. The sale-leaseback prohibition would be modified to permit a de minimis leaseback to the seller (or a party related to the seller) of debt-financed real property. The de minimis exception would apply only if (1) no more than 10 percent of the leasable floor space in a building is leased back to the seller (or related party) and (2) the lease is on commercially reasonable terms.

Seller financing exception. The prohibition on seller-financing would be modified to permit seller-financing on terms that are commercially reasonable. Standards would be provided for determining a commercially reasonable interest rate for this purpose. Because of the separate prohibition on debt-financed income measured by revenue, income, or profits, a participating loan (including an equity kicker) would not under this proposal be considered a commercially reasonable term. The seller-financing exception would not be available if the seller is related to the qualified trust (or to any plan with respect to which the trust was formed) or to the educational institution (including as a substantial contributor).

2. Special Rules for Investments in Partnerships.

The sale-leaseback rules would not apply to an investment made by a qualified trust or educational institution in a large partnership (that is, a partnership having at least 250 partners) if (1) investment units in the partnership are marketed primarily to taxable individuals; (2) a significant percentage (at least 50 percent) of each class of interests is owned by taxable individuals; (3) the partners that are qualified trusts or educational institutions participate on substantially the same terms as taxable individuals owning interests of the same class; and (4) a principal purpose of the partnership allocations is not tax avoidance. In the case of any partnership other than a large partnership in which taxable partners own a significant (at least 25 percent) interest, the sale-leaseback rules would not apply to an investment made by a qualified trust or educational institution if the partnership satisfies the allocation rules presently applicable to debt-financed investments in real estate through partnerships. In addition, the rule that automatically subjects investments in publicly traded partnerships to UBIT would be repealed for all tax-exempt investors. Thus, such investments would be subject to UBIT only if the activity conducted by the partnership is unrelated to the exempt purpose of the partner or is taxable under the debt-financed rules (as modified by this proposal).

3. Special Exception for Property Foreclosed on by Financial Institutions. In the case of certain sales of property foreclosed on by financial institutions, the prohibition on participating loans would be relaxed as part of a further modification to the proposal described above relating to seller-financing. This special rule would apply only in a case where (1) the qualified trust or educational institution acquires the property from a financial institution (including an institution in receivership) that acquired the property by foreclosure; (2) the financial institution treats the property as an ordinary income asset and the amount of the seller financing does not exceed the amount of the financial institution's outstanding indebtedness (determined without regard to accrued but unpaid interest) with respect to the property at the time of foreclosure; (3) the terms and interest rate are commercially reasonable; and (4) the value of any equity participation feature (including an equity kicker) does not exceed 25 percent of the principal amount of the seller-provided loan and must be paid no later than the earlier of satisfaction of the loan or disposition of the property. Standards would be provided for determining a commercially reasonable interest rate for this purpose.

4. Effective Date. The proposal would generally be effective for debt-financed acquisitions of real estate on or after February 1, 1992, and for partnership interests acquired on or after February 1, 1992.

Effects of Proposal

Pension funds and educational institutions are a major source of investment capital for real estate. The debt-financing rules, which were designed to prevent abuses in transactions between taxable and tax-exempt persons, are overbroad, and impose needless transaction costs which impede the efficient flow of capital. The proposal would eliminate these problems while continuing rules that prevent abusive transactions.

Revenue Estimate

	Fiscal Years						
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1992-97</u>
	(Billions of Dollars)						
Facilitate real estate investments by pension funds and others:	_*	_*	_*	_*	_*	_*	_*

* Less than \$50 million.

REPEAL LUXURY TAX ON AIRCRAFT AND BOATS AND REPEAL DIESEL FUEL EXEMPTION FOR PLEASURE BOATS

Current Law

An excise tax is imposed on the first retail sale of boats and aircraft. The tax is equal to 10 percent of the excess of the sales price over \$100,000 for boats and \$250,000 for aircraft. The tax is also imposed on parts and accessories that are installed on new boats or aircraft within 6 months of purchase, and on the use of boats and aircraft before there has been a retail sale. The tax is not imposed on boats or aircraft that will be used in the active conduct of a trade or business. Most diesel-powered pleasure boats are subject to the tax. In addition, aircraft sold for more than \$250,000 are subject to the tax unless the purchaser keeps records for 2 years showing that the business-use requirement has been satisfied. The tax applies to sales or uses between January 1, 1991 and December 31, 1999.

An excise tax of 20.1 cents per gallon is generally imposed on the sale of diesel fuel that is sold for use (or used) in a diesel-powered highway vehicle. The tax does not apply to diesel fuel sold for use in a boat. The revenues from the tax are split between three funds: 2.5 cents per gallon is retained in the general fund, 17.5 cents per gallon goes to the Highway Trust Fund, and .1 cent per gallon goes to the Leaking Underground Storage Tank Trust Fund.

Reasons for Change

The excise tax on boats and aircraft raises very little revenue and causes inappropriate economic dislocations.

Proposal

The Administration proposes to repeal the excise tax imposed on boats and aircraft. The repeal would be effective for sales on or after February 1, 1992.

The revenue loss resulting from the repeal would be offset by extending the excise tax on diesel fuel to diesel fuel sold for use (or used) in pleasure boats.² The change in the tax on diesel fuel would generally not affect business users. The change would be effective July 1, 1992 and revenues attributable to the change would be retained in the general fund.

²The Administration has not proposed an offset for the repeal of the airplane luxury tax because collection experience indicates that the revenue to be raised by the tax over the next 5 years is less than \$5 million. However, the cost of repeal could be offset by increasing the tax rate on noncommercial jet fuel by \$0.001 per gallon.

Effects of Proposal

The extension of the diesel fuel tax would provide the revenue needed to offset the repeal of the luxury tax on boats and aircraft without significant dislocational effects. The burden of the new diesel fuel tax would be borne primarily by persons who own motor boats costing more than \$100,000.

Revenue Estimate

	Fiscal Years						
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1992-97</u>
	(Billions of Dollars)						
Repeal luxury tax on aircraft and boats and repeal diesel fuel exemption for pleasure boats:	-*	*	*	*	*	*	*

* Less than \$50 million.

FAMILIES, HEALTH, EDUCATION AND SAVINGS

PERMIT DEDUCTION OF INTEREST ON STUDENT LOANS

Current Law

Under current law, interest on educational loans is considered personal interest and is not deductible. Nondeductible personal interest also includes interest on consumer loans, such as car loans or credit card debt incurred to buy consumer goods.

Current law allows a deduction for qualified mortgage interest, which can include interest on a home equity loan. A taxpayer can deduct interest on a home equity loan that is secured by a qualified residence, except that interest on a home equity loan generally cannot be deducted to the extent the loan exceeds the lesser of \$100,000 or the amount of the taxpayer's equity in the residence. How the taxpayer uses the proceeds of a home equity loan does not affect the deductibility of the interest. Thus, a taxpayer can deduct interest on a home equity loan that is used to pay for educational expenses.

Reasons for Change

To remain competitive in the international economy, the nation must have a well-educated, well-trained workforce. A deduction for interest costs incurred in financing higher education and training would encourage individuals to pursue and complete courses of study requiring higher education and vocational training.

Proposal

In general, the proposal would allow a deduction for certain interest expenses incurred to pay for education above the high school level, including vocational education and job-related courses. The deduction would be allowed for interest paid on or after July 1, 1992, and would be taken as an itemized deduction. The deduction would be available for interest on existing loans as well as loans incurred after enactment.

Under the proposal, a taxpayer could deduct interest paid during the year on qualifying educational loans. For a loan to qualify, a number of conditions would have to be met. The loan would have to be made pursuant to a Federal or State guarantee or insurance program, by a tax-exempt nonprofit organization, by a financial institution under a type of program requiring payment to an educational institution, or by an accredited educational or vocational institution. In addition, the loan would have to be a conventional student loan, with conventional repayment terms, and would have to be incurred to pay for certain types of educational expenses. These expenses would have to be paid or incurred at a time that is reasonably contemporaneous with the time the loan proceeds are received.

Eligible educational expenses would include tuition and related expenses of the taxpayer, or the taxpayer's spouse or child, for attendance as a student at an educational institution. The student would have to be either a high school graduate or over age 18, and would have to be pursuing a course of study that either led to a degree or certificate or was related to present or future full-time employment. Eligible educational expenses related to tuition would include fees, the cost of books, supplies, and equipment, and reasonable living expenses of the student if the student lived away from home while attending the educational institution. Tuition or related expenses would not be eligible if a third party reimbursed the taxpayer or the taxpayer's spouse or child for the expenses.

The proposal would coordinate the deduction for qualified educational interest with the deduction for interest on home equity indebtedness. If a taxpayer with qualified educational indebtedness also had home equity indebtedness, the amount the taxpayer could treat as home equity indebtedness for any period would be reduced by any amount treated by the taxpayer as qualified educational indebtedness for that period. For example, if a taxpayer had an existing home equity loan of \$150,000 in 1993 and incurred qualified educational indebtedness of \$20,000 in that year, the taxpayer could only treat \$80,000 of the home equity loan as home equity indebtedness in 1993 (applying first the \$100,000 limitation and then the reduction for qualified educational indebtedness). If in 1994 the taxpayer incurred an additional \$15,000 of qualified educational indebtedness, the taxpayer could only treat \$65,000 of the home equity loan as home equity indebtedness in 1994. To avoid reduction of the interest deduction on the home equity loan as a result of a lower interest rate (or no current payments) on the educational indebtedness, a taxpayer would be permitted to elect, for any taxable year, to forego the educational indebtedness interest deduction and deduct the interest on up to \$100,000 of home equity indebtedness.

Under the proposal, lenders receiving interest on qualified educational indebtedness would be required to file annual information returns with the IRS.

Effects of Proposal

By encouraging individuals to pursue and complete courses of study requiring higher education or vocational training, the proposal would increase the nation's pool of well-educated workers.

Revenue Estimate

	Fiscal Years					
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>
	(Billions of Dollars)					
						<u>1992-97</u>
Permit deduction of interest on student loans:	-0.1	-0.4	-0.7	-0.7	-0.8	-0.9
						-3.6

ESTABLISH FLEXIBLE INDIVIDUAL RETIREMENT ACCOUNTS (FIRAS)

Current Law

Taxation of Investment Income and Saving. Investment income earned by an individual taxpayer is generally subject to tax. The funds saved out of each year's income, which are used to make additional deposits to savings or other investment accounts, additional purchases of stocks or bonds, or to acquire other investments, are generally not deductible in calculating taxable income, and the income from such investments is generally subject to tax. The major exception is the tax treatment of retirement savings under certain tax-favored retirement savings arrangements, contributions to which are generally deductible and investment earnings of which are generally excludable from gross income. These investments are generally taxed when the amounts contributed and earned are later distributed, but the income earned from these investments is in effect never taxed.

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

Married individuals who both work and otherwise qualify may each contribute to an IRA, so that each may contribute up to \$2,000 if each spouse has compensation of \$2,000 or more. Each \$2,000 limit on deductible contributions is then proportionately reduced for AGIs in the applicable phase-out ranges. If only one spouse works, qualifying married individuals also have the opportunity to contribute an additional \$250 to an IRA for the nonworking spouse. The combined \$2,250 limit on deductible contributions is also then proportionately reduced for AGIs in the applicable phase-out ranges.

Withdrawals from an IRA prior to age 59½ are generally subject to a 10 percent additional tax unless arrangements are made to withdraw substantially equal amounts over the taxpayer's expected remaining life. Except for distributions of amounts that were not deductible when contributed, IRA withdrawals are subject in full to the regular income tax. Withdrawals must begin by age 70½, and are subject to minimum withdrawal requirements thereafter.

In economic terms, deductible IRAs effectively exempt investment income from taxation. (The income tax imposed on withdrawals merely recaptures the tax saved from deducting the contribution, plus interest on that tax savings; the investment income itself is effectively exempt from tax.) This favorable tax treatment provides an incentive to save: IRAs are designed to provide this incentive specifically for retirement savings. The tax exemption of investment income is also a feature of section 401(k) and other tax-qualified retirement arrangements. Nondeductible IRAs allow only a deferral of taxes on investment income, not an exemption.

Reasons for Change

There is general concern that the rate of national saving and investment is too low relative to that needed to sustain future growth and to maintain our economic position relative to that of other industrial nations. Addressing this problem requires that both public dissaving (the budget deficit) be reduced, and that private saving be increased in such a way as to increase net national savings. Incentives provided by the proposed FIRAs will provide an important incentive to encourage private saving.

The availability of savings accounts in the form of IRAs was sharply curtailed by the Tax Reform Act of 1986, which resulted in a large decline in IRA participation. Prior to the Act, any individual under the age of 70½ could make deductible contributions, up to the current dollar limits, to an IRA. One of the goals of the current proposal is to expand the availability and attractiveness of tax-exempt saving to a large segment of the population.

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

Proposal

The FIRA differs from a deductible current-law IRA in two respects: the contributions are not deductible, but, if the contributions are retained in the account for at least 7 years, neither the contributions nor the investment earnings are taxed when withdrawn. As in the case of IRAs, the economic effect of a FIRA is to exempt investment income from taxation. The proposal would allow individuals (other than dependents) to make nondeductible contributions to a FIRA up to the lesser of \$2,500 (\$500 more than the \$2,000 maximum currently allowed for IRAs) or the individual's compensation for the year. For purposes of determining the contribution limits, married taxpayers filing a joint return would each be treated as earning half the compensation reported on the return. Contributions would be allowed for single filers with AGIs of no more than \$60,000, for heads of households with AGIs of no more than \$100,000, and for married taxpayers filing joint returns with AGIs of no more than \$120,000. Contributions to FIRAs would be allowed in addition to contributions to current-law qualified pension plans, IRAs, section 401(k) plans, and other tax-favored forms of saving.

Earnings on contributions retained in the FIRA for at least 7 years would be eligible for full tax exemption upon withdrawal. However, withdrawals of earnings allocable to contributions retained in the FIRA for less than 3 years would be subject to both a 10 percent additional tax and the regular income tax. Withdrawals of earnings allocable to contributions retained in the FIRA for 3 to 7 years would be subject only to the regular income tax. The proposal would be effective for years ending on or after December 31, 1992.

An individual otherwise eligible to contribute to a FIRA would be allowed to transfer amounts from existing IRAs (other than an IRA formed from amounts rolled over from a qualified plan) to a FIRA (without regard to the \$2,500 limitation) from February 1 through December 31, 1992. Such amounts (including initial contributions and accumulated interest) would be subject to the regular income tax, but would not be subject to the additional 10 percent tax for premature withdrawals. In addition, the regular income tax due on such transfers would not be due immediately, but would be spread over

a period of 4 years. The 3- and 7-year holding periods would begin to run on the date of the rollover contribution.

Effects of Proposal

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

The ability to contribute to a FIRA would significantly raise the total amount of allowable contributions to tax-favored savings accounts. The contribution limit is generally \$5,000 for a married couple filing a joint return, even if only one spouse has compensation income. In contrast, the \$4,000 IRA limit for a married couple is available only if each spouse has compensation income of at least \$2,000. These higher total contribution limits for FIRAs will provide additional marginal incentives for personal saving. The higher eligibility limits on FIRAs also extend the incentives to more taxpayers.

Despite the difference in structure, the value of the tax benefits (in present value terms) of a FIRA per dollar of contribution is equivalent to the value of the tax benefits of a current-law deductible IRA, assuming that tax rates are constant over time. Both FIRAs and deductible IRAs effectively exempt all investment income from tax. The contributions to FIRAs are not deductible, but the income tax imposed on withdrawals from an IRA effectively offsets the tax savings from the deduction of the contribution (plus interest on the tax savings). Individuals who expect, at the time the funds are withdrawn, to be subject to tax at rates as high or higher than their current rates would generally prefer the tax treatment offered in a FIRA to that in an IRA. Conversely, individuals who expect to be taxed at lower rates at the time the funds are withdrawn would generally prefer an IRA as a vehicle for retirement savings.

However, the FIRA offers more flexibility, because full tax benefits are available 7 years after contribution, and the account need not be held until retirement. This gives individuals an added degree of liquidity. In addition, because individuals are allowed to roll amounts over from an existing IRA to a FIRA, this additional liquidity is also available to individuals whose savings are currently placed in an IRA.

Revenue Estimate

	<u>1992</u>	<u>1993</u>	Fiscal Years				
			<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1992-97</u>
			(Billions of Dollars)				
Establish flexible IRA accounts:	0.1	0.5	0.1	-0.4	-1.0	-2.1	-2.8

PROMOTE RETIREMENT SAVING AND SIMPLIFY TAXATION OF PENSION DISTRIBUTIONS

1. Small Business Model Retirement Plan

Current Law

Simplified Employee Pension. Under a Simplified Employee Pension (SEP) contributions are made to an Individual Retirement Account (IRA) established on behalf of each participant. Because a SEP is an alternative form of an employer-sponsored pension plan, the contribution limits that apply to each employee in the SEP are the limits that apply to employer-sponsored pension plans in general, as opposed to the \$2,000 maximum on contributions that normally applies to IRA contributions. In general, the employer is required to make a contribution for each employee who has attained age 21, has performed service for the employer during at least 3 out of the last 5 years and receives at least \$374 (indexed) in compensation in the year. An employer contribution to a SEP is not taxable income to the employee at the time the contribution is made.

Salary Reduction Arrangement Within a Simplified Employee Pension. If an employer has less than 25 employees who meet the eligibility requirements for receiving a contribution under a SEP, the employer may include a salary reduction arrangement in the SEP. Under the salary reduction arrangement, an employee may elect to have the employer contribute a portion of his or her compensation to the SEP, in lieu of the employer paying the same amount directly to the employee as cash. These contributions are known as elective deferrals. There are nondiscrimination rules, similar to the nondiscrimination rules applicable to section 401(k) plans, that govern the amount that each individual highly compensated employee can defer under such a salary reduction arrangement.

Reasons for Change

Pension plan coverage for employees of small business is low. Small businesses need an affordable, easy to administer pension program for their employees. According to the Department of Labor, while 66 percent of employees in firms with 100 or more employees are covered by pension plans, only 23 percent of employees in firms with less than 100 employees have pension coverage. Under the proposal, the Small Business Model Retirement Plan would be available to nearly 95 percent of America's businesses. The proposal would also encourage expansion of coverage by providing employers with a simplified salary reduction plan that does not require nondiscrimination testing provided the required base contributions are made on behalf of all eligible employees and the employer agrees to make matching contributions at a specified level.

Proposal

A small business (defined as a business that normally employs less than 100 employees throughout the year) that has no other pension plan can provide a Small Business Model Retirement Plan for its employees. An employer that sponsors a Small Business Model Retirement Plan will be required to contribute 1 percent of pay into an account for the benefit of each employee who meets the eligibility requirements to receive a contribution under a SEP. Employees will be eligible to make elective deferrals into their accounts up to a maximum contribution of \$3,000, subject to the section 415 limitation on contributions. To encourage employees to elect deferrals, the employer must make

matching contributions equal to the first 3 percent of compensation that an employee elects to defer plus 50 percent of the employee's elective deferrals that represent between 3 percent and 5 percent of the employee's compensation. The Small Business Model Retirement Plan would generally replace the Salary Reduction SEP under existing law.

2. Cash or Deferred Arrangements and Matching Plans

Current Law

An employer may sponsor a section 401(k) plan that provides employees the ability to defer some of the compensation that they would otherwise receive in cash into a qualified retirement plan. The amount that highly compensated employees may defer into the plan is limited by the degree that nonhighly compensated employees make deferrals under the special average deferral percentage (ADP) test under section 401(k)(3). Plans may also provide for employer matching contributions and employee after-tax contributions.

Actual Deferral Percentage Test. To satisfy the ADP test, the average of the deferral rates (expressed as a percentage of compensation) for each highly compensated employee eligible to participate in the plan generally cannot exceed the greater of (1) 125 percent of the average of the deferral rates for the current year of all nonhighly compensated employees eligible to participate in the plan or (2) the lesser of (a) 200 percent of such average, and (b) such average plus 2 percentage points. Among the permitted remedies for failure of the ADP test is the recharacterization of the deferrals as after-tax employee contributions.

Contribution Percentage Test. If a plan permits after-tax employee contributions, or provides for employer contributions that are contingent on a participant's elective deferrals or after-tax employee contributions ("matching contributions"), the amount of such contributions generally must satisfy a special average contribution percentage (ACP) test under section 401(m)(2). The ACP test generally is the same as the ADP test described above, except that it applies to matching and after-tax employee contributions rather than to elective deferrals.

Where contributions to a plan are subject to both the ADP test and the ACP test described above, special rules apply to preclude the full amount of the alternative limit (i.e., the 200/2 percentage points limit) to be used in both tests.

Reasons for Change

Because the present law ADP test is based on current year deferrals and because the test is based on averaging of the deferral rates for eligible employees, the maximum deferral permitted for the highly compensated employees is not known until year end. As a result, excess deferrals can occur, and the correction methods are cumbersome. If employers could base the ADP test on prior year deferrals by the nonhighly compensated group, one of the variables that determines the extent that an individual highly compensated employee is permitted to defer is known at the beginning of the year. For employers who wish to remove all the uncertainty as to whether the deferrals of highly compensated employees will satisfy the ADP test, an option could be provided to apply the ADP on the basis of each individual highly compensated employee's deferral rate (rather than the average of such rates). This

would minimize, if not eliminate, excess deferrals and the necessity for correction. Similar considerations apply with respect to the present law ACP test.

The multiple use test adds unnecessary complexity to the ADP and ACP tests. The ability to recharacterize excess deferrals as after-tax contributions also adds unnecessary complexity where modifications to the ADP and ACP tests will minimize, if not eliminate, excess deferrals.

Proposal

The ADP test would be modified such that the determination of the amount that highly compensated employees can defer is based on the average of the deferral rates for the eligible nonhighly compensated employees for the preceding plan year. In the case of an employer that has not previously maintained a 401(k) plan, the ADP test for the first plan year would be calculated as if the nonhighly compensated employee deferral rate was 3 percent.

The ADP test would be further modified by providing employers with an election to apply the current law ADP test (as modified as described in the preceding paragraph) or to apply a simplified ADP test. Corresponding modifications would be made to the ACP test.

Under the simplified ADP test, each eligible highly compensated employee individually would not be permitted to defer more than a prescribed amount based on the average of the deferral rates for the eligible nonhighly compensated employees. If the nonhighly compensated employee deferral rate was between zero and 3 percent, each highly compensated employee could defer an amount up to 2 times that rate. If the nonhighly compensated employee deferral rate was greater than 3 percent, each highly compensated employee could defer an amount up to that rate plus 3 percentage points. Under this simplified ADP test, the multiple use test would not apply and the employer would not be permitted to recharacterize excess deferrals as after-tax employee contributions.

3. Definition of Highly Compensated Employees and Family Aggregation Rules

Current Law

Various qualified pension plan requirements (principally those relating to nondiscrimination requirements) require a determination of the employer's highly compensated employees. The term "highly compensated employee" is defined to include any employee who during the current or preceding year (1) was a 5-percent owner, (2) earned over \$75,000 (indexed), (3) earned over \$50,000 (indexed) and was in the top 20-percent of the employer's workforce by compensation, or (4) was an officer earning compensation over \$45,000 (indexed) or was the highest paid officer, if no officer earned more than the stated amount. Certain family aggregation rules apply in the case of 5-percent owners and other highly compensated employees who are among the top 10 employees by compensation. These family aggregation rules apply for purposes of identifying highly compensated employees and for purposes of applying the compensation limit under qualified plans.

Reasons for Change

Eliminating the rules regarding officers and the top 20 percent of employees by compensation would simplify the current rules. In addition, by generally basing the determination of highly

compensated employees on the prior year compensation, an employer would be able to determine its highly compensated employees at the beginning of a year. Among other things, this will facilitate determining compliance with the various qualified plan nondiscrimination rules (including those applicable to 401(k) plans).

The family aggregation rules are a source of great complexity and create inequities for two wage earner families where both spouses work for the same employer.

Proposal

The term "highly compensated employee" would be redefined to include only 5-percent owners and employees who earn over \$50,000 (indexed). If an employer had no highly compensated employees under this definition, then the one employee with the highest compensation would be treated as highly compensated. In addition, compensation generally would be determined based on the prior year's compensation. Finally, the family aggregation rules would be repealed.

4. Cash or Deferred Arrangements for Employees of Tax-Exempt Employers

Current Law

Tax-exempt employers cannot adopt qualified cash or deferred arrangements (section 401(k) plans) for their employees. Certain existing plans adopted before July 2, 1986 were grandfathered. Similar rules apply to State and local governmental employers.

Reasons for Change

Certain tax-exempt employers (e.g., section 501(c)(6) trade associations or section 501(c)(18) credit unions) are not permitted currently to offer any type of broad-based salary reduction program to their employees. In addition, section 401(k) plans offer certain advantages over alternative vehicles available to other tax-exempt employers. For example, amounts deferred under a section 401(k) plan must generally be held in trust, while amounts deferred under section 457 plans (unfunded deferred compensation plans of tax-exempt employers) must remain subject to the general creditors of the employer. As a matter of equity, employees of tax-exempt employers should have the same retirement vehicles available to them as private employers.

Proposal

Tax-exempt employers would be permitted to adopt section 401(k) plans for their employees. Current law would continue to apply to State and local governmental employers.

5. Promote Retirement Saving and Simplify Taxation of Pension Distributions

Current Law

Distributions from qualified plans and other tax-preferred retirement programs are generally subject to income tax upon receipt. Premature distributions, generally those made before age 59½, may also be subject to a 10-percent additional tax under section 72(t). In addition, excess distributions (generally those in excess of \$150,000) are subject to a 15-percent excise tax. A number of special rules may alter the general rule, if applicable.

Lump Sum Distributions. Certain lump sum distributions from qualified plans are eligible to be taxed under special rules with respect to both the income tax and excise tax provisions. A participant may be able to elect to use the 5-year forward averaging rules in determining the income tax on a lump sum distribution if the distribution is received after attainment of age 59½ and other requirements are met.

Participants who attained age 50 before January 1, 1986, have several additional options which may reduce the rate of tax on a lump sum distribution. First, they may elect to use the 5-year forward averaging rules even if they are younger than the currently prescribed age requirements if all other the requirements for using those rules are met. In addition, they may elect to use the 10-year forward averaging rules that were available before the Tax Reform Act of 1986. Finally, they may elect to have the entire portion of a lump sum distribution attributable to pre-1974 participation taxed at a 20 percent rate.

If a lump sum distribution includes securities of the employer corporation, the "net unrealized appreciation" (NUA) generally is not subject to tax until the securities are sold, unless the recipient elects to have the normal distribution rules apply. When the securities are sold, the NUA is treated as long-term capital gain. If a distribution is not a lump sum distribution, only the NUA attributable to the employee's own contributions may be excluded from income under these special rules.

Rollovers. Current income tax and, if applicable, the additional tax on a premature distribution can be avoided if the taxable portion of an eligible distribution is "rolled over" within 60 days to an individual retirement account (IRA) or to another qualified plan. Only "qualified total distributions" or "partial distributions" are eligible for rollover treatment. Neither after-tax employee contributions nor minimum required distributions may be rolled over.

Reasons for Change

The tax treatment of qualified plan distributions is unnecessarily complex. The burden of this complexity falls primarily on plan participants and beneficiaries, who may not know the rules governing rollovers or the tax consequences of failing to take timely action. Given the 1986 changes in the basic structure of the individual tax rates and brackets, the highly complex rules for forward averaging, NUA, and capital gains treatment are no longer needed. The liberalized rollover proposal facilitates the retention of pension benefits in retirement savings vehicles, such as IRAs which give the participant control over the timing of distributions.

The single largest source of lost pension benefits is preretirement cashouts of pension savings in lump sum distributions. The proposal would facilitate the preservation of such benefits for retirement purposes by permitting employees to direct the transfer of their benefits to an IRA.

Proposal

Lump Sum Distributions. The 5-year forward averaging for lump sum distributions and the special tax treatment for NUA would be repealed. The special rules making 10-year forward averaging and capital gains treatment available to individuals who attained age 50 before January 1, 1986 would be phased out over a number of years. As under current law, one lump sum distribution of up to \$750,000 would be exempt from the excise tax on excess distributions.

Rollovers. In general, most of the restrictions on the types of distributions eligible for rollover treatment would be eliminated. The only distributions not eligible for rollover treatment would be periodic distributions made in the form of an annuity payable for the life of the participant (or the joint lives of the participant and his or her designated beneficiary) or distributions payable in installments over a period of 10 years or longer. The current law restrictions on the rollover of after-tax employee contributions and of minimum required distributions would be retained.

In addition, a qualified plan making a distribution that is eligible for rollover treatment would be required to give the employee the option of having the distribution transferred directly to an IRA or another qualified plan.

6. Taxable Portion of Pension Payments

Current Law

Distributions from a qualified retirement plan are generally subject to income tax when paid, except to the extent that the distribution constitutes a return of the employee's investment (primarily composed of after-tax contributions made by the employee). The portion of the payment that is excludable from tax is equal to the employee's investment divided by the "expected return". The expected return is the total annual annuity payment multiplied by the distributee's remaining life expectancy at retirement. In addition, up to \$5,000 in death benefits paid by an employer may be excluded from gross income. If the death benefit is paid in the form of an annuity, the benefit is included in the employee's investment amount. Payors of pensions are required to report total pensions distributions and annuity payments and other partial payments from pension plans.

Reasons for Change

The rules for determining the tax consequences of a pension distribution are complicated and burdensome. The proposal would simplify current law by adopting a single, simpler method for determining the amount of tax.

Proposal

The death benefit exclusion would be repealed. The general rule for calculating the taxable portion of a distribution would be replaced with the alternative method currently provided in IRS Notice 88-118.

7. IRS Master and Prototype Program

Current Law

The IRS currently administers a master and prototype program under which trade and professional associations, banks, insurance companies, brokerage houses, and other financial institutions can obtain IRS approval of model retirement plans and make the pre-approved plans available for adoption by their customers, investors or association members. Under similar administrative programs, law firms and other organizations are able to get advance approval of model plans.

Reasons for Change

As the laws relating to retirement plans have become increasingly complex, employers have experienced an increase in the frequency and cost of amending plans and in the burdens of administering the plans. Master and prototype plans, and other model plans, reduce these costs and burdens, particularly for small to medium sized employers. They also improve IRS administration of the retirement plan rules. Today, the majority of employer-maintained tax-qualified retirement plans, including 401(k) plans and SEPs, are approved master and prototype plans. While the IRS believes that the further expansion of the master and prototype and other model plan programs is desirable, it is appropriate to provide the IRS with the statutory authority to specifically define the duties of model plan sponsors as the program becomes more widely utilized.

In addition, ERISA and the Code generally prohibit plan amendments which have the effect of eliminating certain subsidies or optional forms of benefit under tax-qualified plans. Under the proposal, the Secretary of the Treasury would be authorized to issue regulations which would permit the relaxation of these "anti-cut back" rules when an employer replaces an individually designed plan with an IRS approved model plan, provided that the rights of participants under the individually designed plan were not significantly impaired. This would facilitate the shift by employers from individually designed plans to IRS model plans.

Proposal

Under the proposal, the IRS would be required to define the duties of sponsors of master and prototype and other model plans, consistent with the objective of protecting adopting employers from a sponsor's failure to timely amend the plan and with the objective of insuring adequate administrative services are provided with respect to the plan. Model plan sponsors that did not comply with the duties imposed by the IRS could be precluded from continuing to sponsor model plans.

8. Multiemployer Plan Vesting Requirements

Current Law

Multiemployer plans (i.e., plans sponsored by more than one employer, maintained pursuant to collective bargaining) are permitted to use a 10-year cliff vesting schedule. By contrast, the Tax Reform Act of 1986 subjected single-employer plans to shorter minimum vesting standards (e.g., 5-year cliff vesting or 7-year graded vesting).

Reasons for Change

Reducing vesting schedules for multiemployer pension plans would have a significant effect in enhancing pension benefits and portability for workers covered by these plans. As a matter of equity, the multiemployer plan vesting rules should parallel the single employer plan rules.

Proposal

Multiemployer plans would be subject to the same minimum vesting standards as single-employer plans.

9. PBGC Changes. The minimum funding rules for defined benefit plans would be changed. Details are provided in a separate document describing this and other PBGC reforms.

Revenue Estimate

	<u>1992</u>	<u>1993</u>	<u>Fiscal Years</u>				<u>1997</u>	<u>1992-97</u>
			<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>(Billions of Dollars)</u>		
Promote retirement saving and simplify taxation of pension distributions (Items 1-8):	0.1	*	*	0.3	0.4	0.4	1.1	

*Less than \$50 million.

WAIVE PENALTY FOR WITHDRAWALS FROM IRAS FOR MEDICAL AND EDUCATIONAL EXPENSES

Current Law

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

Withdrawals for IRAs must begin by age 70½. IRA withdrawals, except those from nondeductible contributions, are subject to income tax. Withdrawals from an IRA prior to age 59½ are generally subject to a 10 percent additional tax unless arrangements are made to withdraw substantially equal amounts over the taxpayer's expected remaining life. There is an exception from the 10 percent additional tax under current law for distributions from qualified plans that do not exceed the amount allowable as a deduction for medical care during the year, but this exception does not apply to IRAs.

Reasons for Change

The Tax Reform Act of 1986 sharply curtailed the attractiveness and availability of IRAs for many taxpayers. This resulted in a large decline in IRA participation. Prior to the 1986 Act, any individual under the age of 70½ could make deductible contributions, up to the current limits, to an IRA. The current proposal is designed to enhance the attractiveness of IRAs by making them more flexible. It would also provide an incentive for more taxpayers to save for educational and medical expenses and would provide additional sources of funds to pay these expenses, which can often be significant.

Proposal

The proposal would provide an exception from the 10 percent tax on early withdrawals for distributions from an IRA that do not exceed the amount of qualifying educational expenses of the taxpayer or his or her spouse or child. Qualifying educational expenses are expenses for higher education and post-secondary vocational education. The proposal would also extend the current law exception for distributions from qualified plans for certain medical expenses to distributions from an IRA. The proposal would be effective for withdrawals on or after February 1, 1992.

Effects of Proposal

This proposal would enhance the attractiveness of IRAs. It would also provide an incentive for more taxpayers to save for educational and medical expenses and would provide additional sources of funds to pay these expenses.

Revenue Estimate

			Fiscal Years				
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1992-97</u>
			(Billions of Dollars)				
Waive penalty for withdrawals from IRAs for medical and educational expenses:	-*	-0.1	-0.1	-0.1	-0.1	-0.1	-0.6

* Less than \$50 million.

EXTEND HEALTH INSURANCE DEDUCTION FOR SELF-EMPLOYED

Current Law

Current law generally allows a self-employed individual to deduct as a business expense up to 25 percent of the amount paid during a taxable year for health insurance coverage for himself, his spouse, and his dependents. The deduction is not allowed if the self-employed individual or his or her spouse is 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 of the Code. Section 89 has since been repealed retroactively, however, and no non-discrimination requirements currently apply to such insurance. The value of any coverage provided for such individuals and their families by the business is not deductible for self-employment tax purposes. The availability of the deduction was extended by the Tax Extension Act of 1991 and is currently scheduled to expire June 30, 1992.

Reasons for Change

The 25 percent deduction for health insurance costs of self-employed individuals was added by the Tax Reform Act of 1986 because of a disparity between the tax treatment of owners of incorporated and unincorporated businesses (e.g., partnerships and sole proprietorships). Under prior law, incorporated businesses could generally deduct, as an employee compensation expense, the full cost of any health insurance coverage provided for their employees (including owners serving as employees) and their employees' spouses and dependents. By contrast, self-employed individuals operating through an unincorporated business could only deduct the cost of health insurance coverage for themselves and their spouses and dependents to the extent that it, together with other allowable medical expenses, exceeded 5 percent of their adjusted gross income. (Coverage provided to employees of the self-employed however, was and remains a deductible business expense for the self-employed.) The special 25 percent deduction was designed to mitigate this disparity in treatment. Further, the Tax Reform Act of 1986 raised the floor for deductible medical expenses (including health insurance) to 7.5 percent of adjusted gross income.

Proposal

The proposal would extend the 25 percent deduction through December 31, 1993.

Effects of Proposal

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

Revenue Estimate

	Fiscal Year						
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1992-97</u>
	(Billions of dollars)						
Extend health insurance deduction for self-employed:	-0.1	-0.2	-0.3	-	-	-	-0.6

EXTEND MEDICARE HOSPITAL INSURANCE (HI) COVERAGE TO ALL STATE AND LOCAL EMPLOYEES

Current Law

State and local government employees hired on or after April 1, 1986, and employees who are not members of their employer's retirement system, are covered by Medicare Hospital Insurance, and their wages are subject to the Medicare tax (1.45 percent on both employers and employees). Unless a State or local government has a voluntary agreement with the Secretary of Health and Human Services, employees hired prior to April 1, 1986, who are members of their employer's retirement system are not covered by Medicare Hospital Insurance, nor are their wages subject to the tax.

Reasons for Change

State and local government employees are the only major group of employees not assured Medicare coverage. One out of six State and local government employees are not covered by voluntary agreements or by law. However, an estimated 85 percent of these employees receive full Medicare benefits through their spouse or because of prior work in covered employment. Over their working lives, they contribute on average only half as much tax as is paid by workers in the private sector. Extending coverage would assure that the remaining 15 percent have access to Medicare and would eliminate the inequity and the drain on the Medicare Trust Fund caused by those who receive Medicare without contributing fully.

Proposal

As of July 1, 1992, all State and local government employees would be covered by Medicare Hospital Insurance.

Effects of Proposal

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

Revenue Estimate³

	Fiscal Years						
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1992-97</u>
	(Billions of Dollars)						
Extend HI coverage to State and local employees:	0.3	1.6	1.5	1.5	1.5	1.5	8.1

³Net of income tax offset.

DOUBLE AND RESTORE ADOPTION DEDUCTION

Current Law

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

Reasons for Change

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

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

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

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

Proposal

The proposal would permit the deduction from income of unreimbursed expenses that are associated with the adoption of special needs children, up to a maximum of \$3,000 per child. Eligible expenses would be limited to those directly associated with the adoption process that are eligible for reimbursement under the Adoption Assistance Program. These include court costs, legal expenses, social service review, and transportation costs. Expenses that are deducted and then reimbursed in a later tax year would be included in income in the year the reimbursement occurs. Only expenses for adopting children defined as eligible under the rules of the Adoption Assistance Program would be allowed. The proposal would be effective for adoptions on or after February 1, 1992.

Effects of Proposal

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

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

Revenue Estimate

	Fiscal Years						
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1992-97</u>
	(Billions of Dollars)						
Double and restore adoption deduction:	-*	-*	-*	-*	-*	-*	-*

* Less than \$50 million.

EXPAND PUBLIC TRANSIT EXCLUSION TO \$60 PER MONTH

Current Law

Certain employer-provided fringe benefits are excluded from gross income under current law. Among the fringe benefits excluded from gross income are so-called "*de minimis* fringes," which are generally defined as any employer-provided property or service the value of which is so small as to make accounting for it unreasonable or administratively impractical. The 1984 legislation creating the exclusion instructed the Treasury to treat as a *de minimis* fringe up to \$15 per month of employer-provided passes, tokens, fare cards and reimbursements to cover the costs of commuting by public transit. Regulations were issued in January 1992 to increase this amount to \$21 to reflect inflation since 1984.

The exclusion for employer-provided commuting benefits applies only if the total value of the passes, tokens, fare cards and reimbursements provided to an employee does not exceed \$21 per month. That is, an employee who receives benefits valued at more than \$21 per month cannot exclude any portion of the value from income, even if the value exceeds \$21 by only a small amount.

Reasons for Change

The Administration believes that a significant increase in the amount of employer-provided public transit commuting benefits that may be excluded from income subject to tax would create a more meaningful incentive for commuting by public transit than the exclusion provided under current law. The Administration also believes that the requirement under current law that the entire value of public transit commuting benefits that exceed the excludable amount be included in income subject to tax may discourage the provision of these benefits.

Proposal

The proposal would allow taxpayers to exclude from gross income up to \$60 per month of employer-provided passes, tokens, fare cards and reimbursements to cover the costs of commuting by public transit, regardless of whether the total amount exceeds \$60. The proposal would apply to benefits covering expenses incurred on or after February 1, 1992.

Effects of Proposal

The proposal would increase incentives for commuting by public transit. Increasing the excludable amount to \$60 would allow taxpayers to exclude up to approximately \$2.75 per work day in commuting expenses from income subject to tax, an amount sufficient to cover the cost of commuting by public transit for many taxpayers. The proposal would also create greater parity between the tax treatment of commuting by public transit and commuting by private automobile, the latter of which benefits from an exclusion from income for employer-provided parking for employees on or near the business premises of their employers.

Revenue Estimate

	Fiscal Years						
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1992-97</u>
	(Billions of Dollars)						
Expand public transit exclusion:	- *	- *	- *	- *	- *	- *	-0.1

* Less than \$50 million.

FAMILY TAX ALLOWANCE

Current Law

In general, a taxpayer is allowed a personal exemption for himself, his spouse, and for each dependent. Personal exemptions are allowed as deductions in computing taxable income. The amount of each personal exemption is \$2,300 for taxable years beginning in 1992.

In general, a child age 18 or under qualifies as a dependent if the taxpayer furnishes over half the child's support. A "child" includes a child by blood, an adopted child, a stepchild, and a child placed with the taxpayer by an authorized placement agency for legal adoption. In addition, a child who is a member of the taxpayer's household and lives with the taxpayer during the entire taxable year may be considered the taxpayer's "child." The amount of the personal exemption is indexed for inflation. Personal exemptions are phased out for high-income taxpayers.

Reasons for Change

Taxpayers incur significant costs in rearing children. An increase in the personal exemption for dependent children is a simple and effective way to decrease the financial burden on families.

Proposal

The proposal increases the personal exemption for dependent children age 18 and under at the end of the taxable year by \$500 per child. This amount would be indexed for inflation. The proposal is effective October 1, 1992.

Effects of Proposal

Under the proposal, the personal exemption for dependent children age 18 or under at the end of the taxable year will increase by \$500 per child. For taxable years beginning in 1992, the increase will be prorated.

Revenue Estimate

	Fiscal Years						
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1992-97</u>
	(Billions of dollars)						
Family tax allowance:	0	-4.4	-4.6	-4.7	-5.0	-5.2	-23.8

HOMEBUYERS

PROVIDE FIRST-TIME HOMEBUYERS A \$5,000 TAX CREDIT

Current Law

There is no tax credit for homebuyers under current law. There are a number of other tax benefits for homeowners under current law. For example, homeowners are allowed to deduct mortgage interest and property taxes if they itemize their deductions. In addition, capital gains on the sale of a principal residence may be deferred if the seller purchases a new principal residence within a specified rollover period and the new residence costs at least as much as the adjusted sales price of the old residence.

Reasons for Change

A temporary tax credit for first-time homebuyers would accelerate the time at which first-time homebuyers purchase a home. By accelerating and increasing expenditures on home purchases, such a credit would also assist in the recovery of the homebuilding industry.

Proposal

First-time homebuyers would receive a tax credit on the purchase of a principal residence. The credit would equal 10 percent of the purchase price of the residence, up to a maximum of \$5,000. Half of the credit would be allowed in the year the residence is purchased and half in the succeeding year. The credit would be available to any first-time homebuyer, regardless of income, and could be taken on the purchase of any residence that is the purchaser's principal residence.

The tax credit would be available for any purchase of a first home on or after February 1, 1992, and before January 1, 1993. For calendar-year taxpayers, half the credit would thus be available to offset 1992 income tax liability and half to offset 1993 income tax liability. Although the credit would not be refundable if it exceeded income tax liability, any unused portion of the credit could be carried forward for up to 5 years if it could not be used in the current year.

For example, if a first-time homebuyer purchased a principal residence in June 1992 for \$80,000, the allowable credit would be the maximum of \$5,000. Under the proposal, the taxpayer could take a credit of \$2,500 in 1992 and \$2,500 in 1993. Alternatively, if the residence cost \$40,000, the allowable credit would be \$4,000; the taxpayer could take a credit of \$2,000 in 1992 and \$2,000 in 1993.

A first-time homebuyer would include any individual who did not own a present interest in any residence at any time during the 3-year period prior to the date of purchasing the principal residence on which the credit is to be claimed. However, if an individual is deferring tax on gain from sale of an old principal residence and is permitted an extended rollover period, that individual would not be considered a first-time homebuyer until after the end of the extended rollover period.

Only a single credit may be claimed per residence and all purchasers must be first-time homebuyers. If the credit is claimed on more than one return (e.g., in the case of a married couple filing a separate return), the credit must be apportioned under rules to be provided in regulations.

The credit would be recaptured if the residence on which the credit is claimed is disposed of within 3 years of the date the residence was purchased. The recapture rule would not apply, however, to dispositions by reason of the taxpayer's death or pursuant to the taxpayer's divorce. If the taxpayer disposed of the residence within 3 years but purchased a new residence within the rollover period, the credit would be recaptured to the extent the taxpayer could not have claimed as much credit on the new residence.

Effects of Proposal

The tax credit would assist first-time homebuyers in entering the housing market to purchase homes. By encouraging such purchases during 1992, the credit would stimulate the housing industry.

Revenue Estimate

	Fiscal Years						
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1992-97</u>
	(Billions of Dollars)						
Provide tax credit to first-time homebuyers:	-0.2	-2.1	-2.5	-0.6	0.2	0.1	-5.2

ALLOW DEDUCTION FOR LOSS ON SALE OF PRINCIPAL RESIDENCE

Current Law

Under current law, a deduction for nonbusiness losses is only available if the losses are casualty losses, and is limited in a number of ways. Casualty losses include losses arising from fire, storm, shipwreck, or other casualty, or from theft. A taxpayer can deduct casualty losses only if the taxpayer itemizes deductions. To calculate the amount of the deduction, the taxpayer must reduce each casualty loss by \$100, and reduce the total amount of casualty losses by 10 percent of the taxpayer's adjusted gross income. Net casualty losses are deductible against ordinary income.

Capital gain on the sale of a residence is taxable unless a specific deferral or exclusion of the gain is available. Capital loss on the sale of a residence, however, is not deductible and cannot offset capital gain.

The tax on capital gain on the sale of a principal residence may be deferred if the seller purchases a new principal residence within a 2-year rollover period and the new residence costs at least as much as the adjusted sales price of the old residence. The tax basis of the new residence is reduced by the amount of any untaxed gain on the sale of the old residence. The 2-year rollover period is extended for certain taxpayers residing abroad and certain military personnel on active duty.

Capital gain on the sale of a principal residence may be excluded by a taxpayer who is age 55 or older and meets certain qualifications. This exclusion is limited to \$125,000 of capital gain and is only available to a taxpayer once.

Reasons for Change

In a period of declining home values, the asymmetry of current law treatment of gains and losses on sales of homes places an inappropriate burden on homeowners who must sell their homes at a loss.

Proposal

The proposal would allow homeowners who sell their homes at a loss to treat the capital loss as a casualty loss, thus allowing a partial deduction. The limitations on deductibility of casualty losses would apply, and the deduction would be available only if the homeowner itemizes deductions.

In addition, the proposal would allow a homeowner who sells a principal residence at a loss and purchases a new principal residence within the 2-year rollover period to add the nondeductible portion of the loss to the tax basis of the new principal residence. The nondeductible portion of the loss would thus reduce gain on eventual sale of the residence. If a homeowner was eligible for a longer rollover period than 2 years by reason of foreign residency or military status, the longer rollover period would apply.

For example, if a homeowner with an adjusted gross income of \$40,000 sold his or her home at a loss of \$10,000 and had no other casualty gains or losses for the year, the homeowner would have a casualty loss deduction from the sale of the home of \$5,900 (\$10,000 less \$100 less 10 percent of adjusted gross income). If the homeowner purchased a new principal residence within 2 years for

\$90,000, the homeowner could add \$4,100 (the nondeductible portion of the \$10,000 loss) to the basis of the new principal residence. Under current law, the homeowner would have a nondeductible capital loss of \$10,000 and no basis adjustment reflecting that loss.

The one-time \$125,000 exclusion would still be available to homeowners who later sold their new principal residences at a gain.

The proposal would be effective for sales of principal residences on or after February 1, 1992. In addition, homeowners who sustained a loss on the sale of a principal residence on or after January 1, 1991 would be permitted to add the entire loss basis to the basis of a new principal residence purchased within the rollover period.

Effects of Proposal

The proposal would benefit homeowners who must sell their homes at a loss, thus easing the tax burden on such individuals. Although the full amount of the loss would not be currently deductible, the partial deduction combined with the basis adjustment would operate to correct much of the current imbalance between treatment of capital gains and capital losses from sales of principal residences.

Revenue Estimate

	Fiscal Years						
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1992-97</u>
	(Billions of Dollars)						
Allow deduction for loss on sale of principal residence:	-*	-0.4	-0.4	-0.4	-0.4	-0.3	-1.9

* Less than \$50 million.

WAIVE PENALTY FOR WITHDRAWALS FROM IRAS FOR FIRST-TIME HOMEBUYERS

Current Law

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

Withdrawals for IRAs must begin by age 70½. IRA withdrawals, except those from nondeductible contributions, are subject to income tax. Withdrawals from an IRA prior to age 59½ are generally subject to a 10 percent additional tax unless arrangements are made to withdraw substantially equal amounts over the taxpayer's expected remaining life.

Reasons for Change

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

The Tax Reform Act of 1986 sharply curtailed the attractiveness and availability of IRAs for many taxpayers. This resulted in a large decline in IRA participation. Prior to the 1986 Act, any individual under the age of 70½ could make deductible contributions, up to the current limits, to an IRA. The current proposal is designed to enhance the attractiveness of IRAs by making them more flexible. It would also provide an incentive for taxpayers to save for the purchase of their first home.

Proposal

The proposal would allow individuals to withdraw amounts of up to \$10,000 from their IRAs for their first purchase of a principal residence. The 10 percent additional tax on early withdrawals would be waived for eligible individuals. Eligibility for penalty-free withdrawals would be limited to individuals who did not own a present interest in a residence at any time during the 3 years period prior to the purchase of the principal residence, or who are not within an extended period for rolling over gain from the sale of a principal residence. The proposal would be effective for withdrawals on or after February 1, 1992.

Effects of Proposal

This proposal would enhance the attractiveness of IRAs and help encourage individuals to save for the purchase of a first home.

Revenue Estimate

	Fiscal Years						
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1992-97</u>
	(Billions of Dollars)						
Waive penalty for withdrawals from IRAs for first-time homebuyers:	-*	-0.1	-0.1	-0.1	-0.1	-0.1	-0.5

* Less than \$50 million.

EXTEND MORTGAGE REVENUE BONDS

Current Law

State and local governments may use the proceeds of tax-exempt bonds to make loans to low and middle income individuals for the purpose of purchasing a single family residence to be used as their principal residence. Tax-exempt bonds used for this purpose are authorized under the Internal Revenue Code as mortgage revenue bonds. In lieu of issuing mortgage revenue bonds, State and local governments may issue mortgage credit certificates (MCC's) to low and middle income individuals with respect to qualifying purchases of principal residences. MCC's provide qualifying purchasers of principal residences a tax credit equal to a portion of the home mortgage interest paid by the purchaser.

Generally, only individuals with family incomes of less than 115 percent of the median family income for the area in which a residence is located are eligible to borrow proceeds of mortgage revenue bonds or to receive MCC's. In addition, the purchase price of a residence purchased with proceeds of mortgage revenue bonds or subsidized with MCC's may not exceed 90 percent of the average purchase price of residences in that area.

Mortgage revenue bonds and MCC's are subject to the tax-exempt bond volume cap and must compete with other private activity bonds for a share of a State's volume cap. The authority to issue mortgage revenue bonds and MCC's was scheduled to expire on December 31, 1991. This authority was extended through June 30, 1992 by the Tax Extension Act of 1991.

Reasons for Change

Programs funded with the proceeds of mortgage revenue bonds that provide loans to low and middle income homebuyers and programs providing MCC's to low and middle income homebuyers have been popular with many State and local governments. Making mortgage revenue bond proceeds and MCC's available to homebuyers results in lower costs of borrowing, thereby making housing more affordable for lower and middle income families. Extending this program will help lower and middle income families acquire residences.

Proposal

The authority to issue mortgage revenue bonds and MCC's would be extended 18 months, to December 31, 1993.

Effects of Proposal

The availability of low-interest rate or subsidized mortgage financing should make home ownership possible for more lower and middle income individuals and families.

Revenue Estimate

	Fiscal Years						
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1992-97</u>
	(Billions of Dollars)						
Extend mortgage revenue bonds:	-*	-*	-0.1	-0.1	-0.1	-0.1	-0.3

* Less than \$50 million.

OTHER PROPOSALS AFFECTING RECEIPTS

SUPPORT REVENUE NEUTRAL TAX SIMPLIFICATION

To reform the burden of taxpayer compliance with the nation's tax law, the Administration will continue to support revenue-neutral simplification of the tax Code, including simplification of tax rules applying to individual taxpayers, relating to amortization of purchased intangible assets and governing payroll tax deposits for small- and medium-sized businesses.

The Administration has set forth its position on specific simplification proposals currently pending before Congress in Treasury Department testimony delivered on July 23, 1991, before the House Committee on Ways and Means; on July 25, 1991, before the Select Revenue Measures Subcommittee of the House Committee on Ways and Means; on July 29, 1991, before the Select Revenue Measures Subcommittee of the House Committee on Ways and Means; on September 10, 1991, before the Senate Committee on Finance; and on October 2, 1991, before the House Committee on Ways and Means.

REVISE RULES FOR CHARITABLE CONTRIBUTIONS

Current Law

Alternative Minimum Tax. In calculating taxable income for ordinary income tax purposes, a taxpayer is generally allowed to deduct (subject to certain limits) the fair market value of property contributed to charitable organizations. The amount of the deduction, however, is generally limited to the taxpayer's basis in the property if a sale of the property would have given rise to ordinary income or to a short-term capital gain. The amount of the deduction is also limited to the taxpayer's basis if the property is tangible personal property and the recipient's use of the property is unrelated to its tax-exempt purpose.

A different rule was adopted in 1986 for donations of long-term capital gain property under the alternative minimum tax (AMT). In computing alternative minimum taxable income (AMTI), the taxpayer may not deduct the full value of the property. Rather, the taxpayer treats as a tax preference, and therefore adds back to AMTI, the amount by which the fair market value of the property exceeds the taxpayer's basis. However, under a special rule that applies for taxable years beginning in 1991 and for contributions made before July 1, 1992 in taxable years beginning in 1992, charitable contributions of tangible personal property do not result in this tax preference.⁴

Source Rule. Under the current statute and regulations, a taxpayer's charitable deductions generally are ratably allocated and apportioned between U.S. source and foreign source gross income. In making this computation, an affiliated group of corporations generally is treated as a single taxpayer. The allocation and apportionment of a charitable deduction to a taxpayer's foreign source income may reduce the allowed foreign tax credit of taxpayers with excess foreign tax credits.

Reporting by Charitable Donees. Section 6033 of the Internal Revenue Code requires most tax-exempt organizations eligible to receive tax-deductible charitable contributions to file an annual information return (the Form 990). However, of these entities, churches and their affiliated organizations and public charities with gross receipts of \$25,000 or less are generally not required to file the Form 990. By regulation, exempt organizations required to file the Form 990 must generally report, among other items, the names and addresses of all persons who contributed, bequeathed, or devised \$5,000 or more (in money or other property) during the taxable year.

In the Revenue Act of 1987, Congress adopted rules requiring exempt organizations other than charities (that is, other than organizations exempt under section 501(c)(3)) to disclose in their fund-raising solicitations that payments to the organization are not deductible as charitable contributions. Charities are not required to disclose, in soliciting donations, the circumstances under which donations, membership dues, payments for goods or services, or other items might not be deductible as charitable contributions.

Reporting by Donors. On Schedule A to the Form 1040, an individual taxpayer must separately state the aggregate amount of charitable contributions made by cash or check and the aggregate amount made other than by cash or check. In addition, on a form attached to the Form 1040, taxpayers must

⁴See Rev. Rul. 90-111, 1990-2 C.B. 30 for the rules that apply to donations made in 1991.

separately identify charitable contributions of property valued at more than \$500. The donor must provide certain specified information about the contributed property, including a description of the property and the date it was acquired, and the method used to determine its fair market value. Generally, a qualified appraiser must sign the form if the claimed deduction exceeds \$5,000 per item or group of similar items. In the case of donated art for which a deduction of \$20,000 or more is claimed, a complete copy of the signed appraisal must be attached.

A taxpayer is not required to provide information regarding specific contributions made by cash or check, regardless of amount.

Reasons for Change

Making the temporary AMT exclusion permanent and expanding it to cover intangible personal property and real property as well as tangible personal property will encourage charitable contributions of property. Items that might otherwise be sold would instead be given to charitable institutions, to the benefit of the general public. Charitable organizations have indicated that since the beginning of 1991, when the temporary exclusion from the AMT for gifts of tangible personal property took effect, gifts of this type of property have increased significantly.

Pro rata allocation and apportionment of charitable deductions on an affiliated group basis may discourage charitable giving by U.S. multinational corporations with excess foreign tax credits. Other methods of allocation and apportionment that could be allowed, by regulation, under the current statute (such as allocation based on the place of use of the charitable gift) may favor some charities over others.

On audit of individual taxpayers, the IRS is not readily able to distinguish between charitable donations to charities and payments to charities for goods and services, such as the admission to entertainment events and the purchase of consumer items. For example, a popular fundraising technique is the use of "charity auctions." Where the winning bidder writes a check to the charity for a large sum of money, significant tax revenues are lost if the taxpayer treats the payment as a charitable contribution rather than as a nondeductible payment for goods or services. Such payments, however, are difficult to identify on the face of the taxpayer's return, if they are aggregated on Schedule A with other cash contributions.

Proposal

Under the proposal, the temporary exclusion from AMTI would be made permanent and would be expanded to include the fair market value of all gifts of appreciated property, including real estate and stocks and bonds. By making permanent the temporary exclusion currently in effect and by expanding that exclusion to all types of property, the proposal restores the exclusion of gifts of appreciated property from the AMT that existed before the Tax Reform Act of 1986. The AMT change would be effective for contributions made in calendar years ending on or after December 31, 1992.

The proposal would also allocate all charitable contribution deductions of a taxpayer to U.S. source gross income to the extent thereof, effective for contributions made in calendar years ending on or after December 31, 1992.

In addition, organizations eligible to receive tax-deductible contributions would generally be required to file information returns with the IRS (and with the donor) reporting charitable contributions received from any individual in excess of \$500 (in cash or property) during the calendar year. The organization would determine whether the amount received is potentially eligible for the charitable contribution deduction, based on whether the organization provided goods or services to the donor. Organizations with annual gross receipts of less than \$25,000 would be exempt from this reporting requirement. It is expected that the IRS would revise Schedule A to the Form 1040 to require individuals who itemize deductions to separately report contributions of more than \$500 (whether in cash or in kind) made in a calendar year to a single organization. The proposal for additional reporting would apply to contributions made on or after July 1, 1992.

Effects of Proposal

The proposal should encourage additional charitable contributions of appreciated property by individuals and by U.S. multinationals with excess foreign tax credits. The proposal also would avoid disadvantaging charities with activities abroad in seeking contributions from such corporations.

Preliminary data collected by IRS under its TCMP program show that taxpayers have frequently overstated charitable contributions. The proposal would reduce the amount of this overstatement by providing the IRS with information needed to monitor the claimed tax treatment of large donations made to charities. In addition, providing information to taxpayers should increase voluntary compliance and should simplify return preparation.

Revenue Estimate

	Fiscal Years						
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1992-97</u>
	(Billions of Dollars)						
Revise rules for charitable contributions:	-*	0.1	0.1	0.1	0.1	0.2	0.6

* Less than \$50 million.

CONFORM BOOK AND TAX ACCOUNTING FOR SECURITIES INVENTORIES

Current Law

Under Treasury regulations, inventories of marketable securities held by dealers for sale to customers 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 items that can be readily valued at the end of each taxable year.

Because inventories of most businesses are difficult to value, however, most taxpayers use the cost method of inventory valuation (often referred to as the "historical cost" method). Under the cost method, a taxpayer values its inventory at the cost reflected on the taxpayer's books until the inventory is sold, and does not recognize any of the unrealized gains and losses that are reflected in the inventory's value. For most profitable 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 cost method will tend to understate the taxpayer's annual income, compared to 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 the Treasury regulations regarding securities dealers were issued, the lower of cost or market method conformed to the best accounting practice in the trade or business, and securities dealers regularly inventoried their unsold securities on that basis in their financial statements. Because the LCM method understates a taxpayer's 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.

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 understate taxable income compared to the market method that securities dealers use to report their income to shareholders and creditors. The market method represents the best accounting practice in the trade or business of dealing in securities and is the method that most clearly reflects the income of a securities dealer.

Proposal

The Administration proposes to eliminate the ability of securities dealers to use the cost and LCM methods. Securities dealers would be required 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.

Each dealer that currently uses the cost or LCM method of accounting for its inventory of securities would be required to change to the market method for all of its securities held for sale to customers. The dealer would be required to value its inventory of securities at market for all taxable years ending on or after December 31, 1992. Under a transitional rule, the resulting change in inventory value would be included in taxable income ratably over a 10-year period. For example, a dealer that uses a calendar year and that is required to change from the LCM method to the market method on December 31, 1992, would increase its taxable income for 1992 and each of the next 9 years by 10 percent of the difference between the market value of its inventory on December 31, 1992, and the value of that inventory on December 31, 1992 under the LCM method.

Effects of Proposal

The proposal would more clearly reflect the annual income earned by dealers in securities.

Revenue Estimate

	<u>1992</u>	<u>1993</u>	<u>Fiscal Years</u>				
			<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1992-97</u>
			(Billions of Dollars)				
Conform book and tax accounting for securities inventories:	0.2	0.6	0.8	0.8	0.8	0.8	4.0

EXTEND 45-DAY INTEREST-FREE PERIOD TO REFUNDS OF ALL TAXES

Current Law

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

Reasons for Change

There is no interest-free period for refunds of taxes other than income taxes (i.e., employment, excise and estate and gift taxes), or for refunds arising from amended returns. This treatment results in taxpayers receiving interest on some overpayments of tax that are refunded within a 45-day period, but not on others, although in all cases taxpayers control the time of filing and the IRS needs a minimum time period to process the return.

Proposal

The Administration proposes to provide a 45-day interest-free period in which the IRS may process refunds of any type of tax overpayment, regardless of whether the refund arises pursuant to an original return or an amended return.

Effects of Proposal

The proposal would eliminate the disparity in the payment of interest on overpayments of income tax and overpayments of other taxes, as well as the disparity in the payment of interest on refunds arising from original tax returns and refunds arising from amended tax returns.

Revenue Estimate

	Fiscal Years						
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1992-97</u>
	(Billions of Dollars)						
Extend 45-day interest-free period:	*	0.3	0.3	0.4	0.4	0.4	1.8

* Less than \$50 million.

DISALLOW INTEREST DEDUCTIONS ON CORPORATE-OWNED LIFE INSURANCE (COLI) LOANS

Current Law

A corporation is allowed to own life insurance policies insuring the lives of its employees and retirees. The investment income on the cash value of these COLI policies is exempt from current taxation, in accordance with the tax treatment provided life insurance policies generally. Interest on indebtedness secured by the cash value of these policies is deductible to the extent the amount of the indebtedness does not exceed \$50,000 per insured life.

Reasons for Change

Corporations that borrow against the cash value of a life insurance policy are able to generate tax savings because the interest paid on the indebtedness is deductible while the build up of investment income on the cash value is not currently subject to tax. The corporation's actual net interest expense is minimal because the interest paid on the loan is approximately equal to the investment income the insurance company credits to the cash value. The Tax Reform Act of 1986 attempted to curtail this tax arbitrage by imposing a \$50,000 per-insured-employee limitation on the amount of indebtedness on which interest may be deducted.

Since 1986, new types of COLI policies have evolved. Under these policies, a corporation insures a large number of employees, and the cash value with respect to each employee's insurance coverage is less than \$50,000. This technique has allowed corporations to avoid the \$50,000 per-insured-employee limitation and shelter large amounts of investment income from current taxation. Furthermore, COLI policies are being structured to pay for health and retirement benefits and could be used to avoid restrictions on benefit plans applicable under other provisions of the Code.

Proposal

The Administration proposes to disallow the deduction for interest paid by corporations on loans secured by the cash value of life insurance policies. The proposal would be effective for interest incurred on or after February 1, 1992.

Effects of Proposal

The proposal would eliminate tax arbitrage on COLI policies by disallowing the deduction for interest expense. Furthermore, it would remove an avenue by which corporations can avoid the nondiscrimination and other restrictions that are generally applicable to deductions for fringe benefit payments. Although the proposal would discourage borrowing against COLI policies insuring the lives of key employees, it would not prevent corporations from purchasing such policies.

Revenue Estimate

	Fiscal Years					
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>
	(Billions of Dollars)					
						<u>1992-97</u>
Disallow interest deductions on corporate-owned life insurance loans:	0.1	0.3	0.4	0.5	0.6	0.6
						2.5

PROHIBIT DOUBLE DIPPING BY THRIFTS RECEIVING FEDERAL FINANCIAL ASSISTANCE

Current Law

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

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 a perverse 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 are enhanced. 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

Under the Administration proposal, FSLIC assistance with respect to (1) any loss would be taken into account as compensation for that loss for purposes of section 165, and (2) 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 a domestic building and loan association 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.

Effects of Proposal

Assisted thrift institutions will no longer have an incentive to minimize the value of covered assets in order to maximize their tax loss on the sale or write-down of these assets and the attendant tax savings. In addition, clarification of the tax treatment of FSLIC assistance will facilitate measures to renegotiate and reduce the cost of the 1988/89 FSLIC transactions.

Revenue Estimate

	<u>1992</u>	<u>1993</u>	<u>Fiscal Years</u>				
			<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1992-97</u>
			(Billions of Dollars)				
Prohibit double dipping by thrifts receiving Federal financial assistance:	0.4	0.4	0.1	*	-*	0.1	0.9

* Less than \$50 million.

EQUALIZE TAX TREATMENT OF LARGE CREDIT UNIONS AND THRIFTS

Current Law

Credit unions are exempt from tax on their income, whether such income is retained or distributed to depositors.

Reasons for Change

Because of their tax exemption, credit unions enjoy a competitive advantage over other financial institutions such as commercial banks and savings and loan associations. Credit unions have grown rapidly since 1951, when savings and loan associations and mutual savings banks became subject to the corporate income tax. Federally insured credit unions accounted for approximately 10 percent of consumer installment credit (not including mortgages) in 1991 and their asset size approximated \$200 billion.

In an economy based on free market principles, the tax system should not provide a tax subsidy to particular commercial enterprises or a competitive advantage to those enterprises over others that perform substantially the same functions. Although credit unions were founded to extend short-term personal loans to narrowly defined groups, today large credit unions frequently function more as full-service consumer banks.

Most credit unions, however, are relatively small. Approximately 94 percent of all Federally insured credit unions have \$50 million or less in assets and approximately 39 percent of all Federally insured credit union assets are held by these smaller institutions.

Proposal

The proposal would repeal the tax exemption for a credit union that has assets of more than \$50 million in any taxable year ending on or after December 31, 1992. Such credit unions would be subject to tax under the same rules that apply to thrift institutions. Credit unions with \$50 million or less in assets would continue to be exempt from tax.

Effects of Proposal

Repealing the tax exemption for large credit unions would place credit unions that perform the same functions as other financial institutions on the same competitive footing as those institutions and would contribute to a more efficient allocation of financial resources. The repeal also would eliminate a distinction under the tax law that is based on historical differences that, in the case of large credit unions, no longer exist.

In addition, the repeal would eliminate the incentive that large credit unions currently have to retain earnings free of tax, rather than distribute them to customer/owners. To the extent that retained earnings are necessary for growth, large credit unions would have to increase the spread between their "dividend" rates and loan rates to cover the Federal tax liability. As with other mutual depository institutions, however, large credit unions could reduce the amount of Federal income tax paid at the corporate level by distributing more "dividends" to depositors or by providing lower loan rates to

borrowers. Distributions of earnings would be included in taxable income currently at the individual level.

Revenue Estimate

	Fiscal Years						
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1992-97</u>
	(Billions of Dollars)						
Equalize tax treatment of large credit unions and thrifts:	0.1	0.2	0.2	0.2	0.2	0.2	1.1

MODIFY TAXATION OF ANNUITIES WITHOUT LIFE CONTINGENCIES

Current Law

The tax law does not distinguish between annuities from which periodic payments are made for the duration of the taxpayer's life and annuities from which periodic payments are not based on the taxpayer's life. Individuals owning either type of annuity receive the tax advantage of deferral of investment income during the accumulation period and favorable basis recovery rules as annuity payments are made.

Reasons for Change

Most deferred annuities allow the owner of the annuity to select a settlement option prior to the time payments begin. The settlement options are generally (1) a pure life or joint lives contingency, (2) a life-contingent annuity containing a term or amount certain feature where annuity payments are guaranteed for a certain term or amount without regard to the time of the annuitant's death, (3) a lump sum payment, and (4) a term certain payment schedule without a life contingency. Deferred annuities that do not have substantial life contingency risks are similar to alternative investments offered by other financial institutions in which the investment earnings are currently taxed. Eliminating the tax advantages of these types of annuities would prevent tax avoidance through the purchase of annuities and reduce incentives to misallocate savings between investment vehicles.

Proposal

The Administration proposes to retain the current-law treatment of annuities, *i.e.*, the deferral of tax on inside buildup during the accumulation phase and the *pro rata* exclusion of basis, only for annuities with substantial life contingencies. For other annuities, investment income would be taxed as earned. The distinction between annuities would be based on whether the annuity contains a substantial risk of loss of investment if the taxpayer dies prematurely. The policy would generally be considered an annuity for tax purposes only if payments were guaranteed (1) for a period of time equal to less than one-third of the annuitant's remaining life expectancy on the annuity starting date, or (2) for less than one-third of the annuity's cash value on the annuity starting date (or date of death, if earlier). Pension annuities and annuities that are part of structured settlements would not be included in this proposal. The proposal would be effective for all annuity contracts entered into on or after February 1, 1992.

Effects of Proposal

By conforming the tax treatment of annuities without substantial life contingencies to the tax treatment of similar investments, the proposal will require investors to decide whether they need the life expectancy protection an annuity offers, and the corresponding risk of loss of their investment due to premature death. For those investors who are primarily interested in tax deferred investment earnings, the proposal may have the effect of reallocating savings to different investment vehicles.

Revenue Estimate

			Fiscal Years					
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1992-97</u>	
			(Billions of Dollars)					
Modify taxation of annuities without life contingencies:	*	0.2	0.2	0.3	0.4	0.5	1.7	

* Less than \$50 million.

EXPAND COMMUNICATIONS EXCISE TAX

Current Law

The communications excise tax is imposed on amounts paid for local telephone service, toll telephone (i.e., long distance) service, and teletypewriter exchange service. The tax does not apply to amounts paid for access to a local digital data network that cannot be used for telephonic (voice) quality communication. It also does not apply to amounts paid for long distance transmission of digital data.

Although the communications excise tax is imposed on amounts paid for local telephone service and toll telephone service, the tax is not imposed on local telephone service paid for by inserting coins in a coin-operated telephone available to the public. A similar exemption applies to long distance telephone service, but only if the total charge is less than 25 cents.

Reasons for Change

Digital data transmission over a local digital data network or over a long distance line is similar to telephonic communication both in purpose and in method of transmission. The communications excise tax should be updated to reflect this technological advance.

The exemptions for coin-operated telephone service are not justified by any fundamental difference in the nature of the services provided. Their anomalous nature is particularly evident when the treatment of local calls from the same public telephone is compared. Calls that are paid for by coin are not subject to the tax, but tax is imposed on calls that are paid for by credit card.

Proposal

The proposal would impose the communications excise tax on amounts paid for access to a local digital data network or for long distance transmission of digital data. The proposal would also repeal the exemptions for coin-operated telephone service. Both changes would be effective July 1, 1992.

Effects of Proposal

The proposed expansion of the communications excise tax would equalize the tax treatment of voice and digital data transmissions over long distance lines and would also equalize the tax treatment of local telephone systems and local digital data networks.

Repealing the exemptions for coin-operated telephone service would eliminate disparities in the tax treatment of amounts paid for essentially equivalent services.

Revenue Estimate

			Fiscal Years				
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1992-97</u>
			(Billions of dollars)				
Expand communications excise tax:	*	0.1	0.1	0.1	0.1	0.1	0.5

* Less than \$50 million.

EXTEND ORPHAN DRUG TAX CREDIT

Current Law

Drugs for the treatment of rare diseases or physical conditions are often called "orphan drugs" because the narrow demand for them discourages taxpayers from undertaking the costly investment in clinical testing that must be completed before manufacture and distribution of the drugs can be approved by the Food and Drug Administration. To encourage development of the drugs, current law allows an elective, non-refundable tax credit for the clinical testing costs incurred by the taxpayer. Although expenses qualifying for the orphan drug credit cannot also qualify for the research and experimentation (R&E) credit, clinical testing expenses do qualify as R&E expenditures for purposes of determining whether the taxpayer's other research expenditures qualify for the R&E credit. If the taxpayer elects to claim the orphan drug credit, no deduction is allowed for an amount of the taxpayer's clinical testing expenses equal to the credit allowable for the taxable year.

The orphan drug credit expires with respect to amounts paid or incurred after June 30, 1992.

Reasons for Change

Although the country benefits from the development of drugs for rare diseases and conditions, taxpayers are not adequately rewarded financially for their clinical testing activities. Clinical testing is long-term in nature, and taxpayers should be able to plan their activities knowing that the credit will be available when the clinical testing is actually undertaken. Thus, if the orphan drug credit is to have its intended incentive effect, it should be made permanent.

Proposal

The Administration proposes to make the orphan drug credit permanent.

Effects of Proposal

Stable incentives allow taxpayers to undertake the development of drugs with greater assurance of future tax consequences. A permanent orphan drug credit permits taxpayers to undertake developmental activities without fear that the tax incentive will not be available when the clinical testing is carried out.

Revenue Estimate

	Fiscal Years						
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1992-97</u>
	(Billions of Dollars)						
Extend orphan drug tax credit:	-*	-*	-*	-*	-*	-*	-0.1

* Less than \$50 million.

MISCELLANEOUS PROPOSALS AFFECTING RECEIPTS

Proposals

Establish Federal Communications Commission (FCC) non-application processing fees. The Administration proposes to establish fees to cover non-application processing costs of the Commission. A portion of the amounts collected from these fees would be dedicated to the expansion of FCC services.

Extend abandoned mine reclamation fees. The abandoned mine reclamation fees, which are scheduled to expire on September 30, 1995, would be extended. Collections from the existing fees of 35-cents per ton for surface mined coal, 15-cents per ton for underground mined coal, and 10-cents per ton for lignite coal are allocated to States for reclamation grants. Abandoned mine land problems are expected to exist in certain States after all the money from the collection of fees under current law is expended.

Increase employee contributions to the Civil Service Retirement System (CSRS). Currently, most CSRS employees and their employing agencies are each contributing 7 percent of base pay to the retirement system. This is less than one-half the accruing cost of CSRS retirement benefits. To prevent further increases in the existing CSRS unfunded liability of \$560 billion, the Administration proposes to increase CSRS employee contributions by 1 percentage point effective January 1, 1993 and by an additional 1 percentage point effective January 1, 1994.

Conform definition of compensation under Railroad Retirement Tax Act to that of social security. The Administration proposes to conform the definition of employee compensation under the Railroad Retirement Tax Act to the definition of employee compensation under social security. Discrepant tax treatment of employee compensation under the two systems results in unnecessary revenue losses to the ailing rail pension trust funds.

Implement Uruguay Round of Multilateral Trade Negotiations. The Uruguay Round of Multilateral Trade negotiations, due to be completed in early 1992, is a wide-ranging and complex negotiation to open global markets and energize world trade. Some aspects of the agreement, particularly the tariff negotiations, will affect customs duties and other tax receipts. Most of these tariff reductions are provided for in the Omnibus Trade and Competitiveness Act of 1988. However some tariff changes likely to be agreed to in the negotiations as well as some non-tariff agreements in the Uruguay Round will require new legislation. This implementing legislation will be transmitted to Congress under the "fast-track" procedures specified in the 1988 Act when the Uruguay Round negotiations are complete.

Revenue Estimate

	<u>1992</u>	<u>1993</u>	<u>Fiscal Years</u>				<u>1992-97</u>
			<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	
			(Billions of Dollars)				
Establish FCC nonapplication processing fees:	0	0.1	0.1	0.1	0.1	0.1	0.4
Extend abandoned mine reclamation fees:	0	0	0	0	0.2	0.3	0.5
Increase employee contributions to CSRS:	0	0.4	1.1	1.2	1.2	1.2	5.1
Conform definition of compensation under Railroad Retirement Tax Act:	0	*	*	*	*	*	0.1
Implement Uruguay Round:	0	-*	*	*	-*	-0.1	-0.1

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Growth Package

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January 28, 1992

President Bush's Plan to Stimulate Economic Recovery, Promote Long-Term Growth, and Expand Opportunity

The President's plan will stimulate economic recovery and job-creating investment; open up opportunity for home ownership and real estate recovery; and help families build for the future. It accomplishes these goals with the following initiatives:

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CUT CAPITAL GAINS TAX RATE

The President urges Congress to cut the capital gains tax rate, which will raise American living standards by unleashing job-creating investment, boosting productivity, and raising the value of the assets of American families.

The President proposes excluding 45 percent of the capital gain on an asset held three or more years; 30 percent of the gain on an asset held between two and three years and 15 percent of the capital gain on an asset held at least one year.

A 45 percent exclusion would effectively cut the capital gains tax to 15.4 percent for taxpayers now subject to a 28 percent capital gains rate and 8.25 percent for taxpayers now subject to a 15 percent tax rate.

Lowering the tax on capital gains to create jobs and make America more competitive is a bi-partisan objective. Many pro-growth Democrats have also proposed a cut in this tax to benefit America's future.

Stimulating Economic Growth and Creating Jobs

- A lower capital gains tax rate lowers the cost of investing in America's future and assures a higher standard of living.
- Because of high capital gains taxes, many important long-term and high risk enterprises have been unprofitable for American firms to undertake.

Opening Up Opportunities for Small Businesses and Entrepreneurs

- America's new companies and small firms are the future strength of the United States. They represent the emerging growth industries that will provide high-quality jobs in the 1990s and the productive muscle to stay competitive in the 21st century.
- Firms with 20 or fewer employees generate over two-thirds of all net new private sector jobs.
- According to the National Federation of Independent Business, the top priority of the small business community is attracting start-up capital. Small businesses and start-up companies traditionally rely on equity capital -- they cannot float bonds or compete with big corporate rivals for bank loans.
- Young companies frequently cannot afford to pay high salaries to attract top talent. Instead, they offer a stake in the business, which will pay off if the company succeeds. A high capital gains rate, which decreases the value of this stake, starves small businesses and entrepreneurs of resources and stunts their growth.

- Lowering the capital gains tax rate will spur entrepreneurs to get their businesses started now, providing jobs for tomorrow.

Raising International Competitiveness

- By keeping the capital gains rate too high, Congress favors foreign jobs over U.S. jobs.
- Many of our fiercest trade competitors encourage investment by not taxing capital gains at all. Germany, South Korea, Hong Kong, Belgium, Italy, and the Netherlands have a zero capital gains tax rate.
- Japan had a zero capital gains rate during most of its post-war economic boom. Even today in Japan an investor in a successful firm pays an effective rate of only 1 to 2 percent.

Spurring Savings and Investment for Economic Growth

- The U.S. needs savings to fund investment in productive enterprises. Yet the tax code penalizes both savings and investment.
- Someone who buys stock in a company is effectively taxed two times: First, the company must pay taxes on its profits before it can pay dividends or reinvest profits. Second, the shareholder must pay income taxes on any dividends or, alternatively, must pay capital gains taxes if he sells the stock for a profit -- even if the profit is illusory because of inflation.

Encouraging Firms to Look Toward the Future

- High capital costs force investors to focus on the short run, rather than the long run. Because of high capital gains taxes, U.S. firms cannot afford to invest in certain long-term projects that their foreign competitors are betting on.
- Due in part to the U.S. tax code, investors find it more attractive to make short-term investments, rather than to wait until a firm innovates, grows, and penetrates markets.
- Because of high capital gains taxes, American firms must promise shareholders much higher returns on their investment. Consider the following example:

An American company and a German company each issue stock worth \$100. Shareholders in both countries demand an after-tax rate of return of 8 percent a year. The German company will invest in a project that will double the stock to \$200 in nine years. The American company will pass up this project. Why? Because capital gains taxes will wipe out up to \$28 of the gain, driving

the annual after-tax return far below the required 8 percent return.

Sharing in America's New Wealth

- All Americans will benefit from the economic growth that a lower capital gains tax rate will bring.
- About half of all Americans report capital gains during their lifetime. About 60 percent of all people who report capital gains earn less than \$50,000. Moreover, over one-quarter earn less than \$20,000.
- Only about 5 percent of tax returns with long-term capital gains have incomes above \$200,000.

o Helping Senior Citizens

- A capital gains tax cut would help senior citizens more than any other group, because retired people no longer earn wages and frequently must sell assets to pay their expenses.
- Many senior citizens sell a family business or a portfolio of stocks that has accumulated over a lifetime to provide a nest egg for retirement years.
- In any year, more than 40 percent of taxpayers over the age of 60 pay capital gains taxes. Senior citizens receive 70 percent of their income from investments, while younger people receive only 15 percent.
- Capital gains for seniors average four to five times the size of capital gains for younger taxpayers.

o Helping America's Families with Middle and Lower Incomes

- People who earn less than \$50,000 of non-capital gains income per year realize about 40 percent of the capital gains each year. A lower capital gains tax applies to many types of assets, not just to the investments that wealthy people make. In fact, capital gains taxes are taxes on the American Dream. For example:
 - the family farm or family business;
 - the great idea that the garage inventor dreams about and turns into a profitable venture;

- the modest rental housing units purchased by the small investor with the family's savings; and
 - the family home that is sold when the kids have grown and moved away, to pay bills, because of divorce, retirement, or the family gets transferred to an area where houses cost less.
- **Helping America's Farmers**
- Cutting the capital gains tax rate would help America's farmers and foresters become even more productive.
 - The Department of Agriculture projects that the President's FY 1992 proposal would have boosted U.S. agriculture output by \$2 billion. These gains, which cut across all agriculture sectors, would also benefit the food processing industry and consumers.
- **Channeling the Wealthy Toward Productive Investment**
- Many wealthy Americans have held onto appreciated assets because of high capital gains taxes. Lowering the tax rate would free up funds for new, job-creating investments.
 - The capital gains tax cuts of 1978 and 1981 raised revenue from millionaires. Taxpayers who earned more than \$1 million paid the federal government \$7.2 billion in 1985, nine times as much as they paid prior to the tax cuts in 1978.

Reducing the Bias Toward Debt Financing

- High capital gains tax rates make stocks less attractive to investors. Rather than issue shares, many firms find it cheaper to go into debt to finance expansion or buy new machinery.
- Under current law when a firm finances by selling stock, the Federal government taxes the same earnings twice. First, the firm pays an income tax. Second, shareholders pay income taxes on these same earnings when they receive dividends or sell shares for a capital gain. In contrast, when a firm finances by selling bonds, the firm may deduct the interest payments as a cost of doing business and investment income is taxed only once at most.
- As capital gains rates rose from 27.5 percent in 1969 to 49 percent in 1976, firms offered less new stock. New public stock offerings fell from \$2.6 billion to \$230 million.

Raising Stock Market Values

- Almost all Americans benefit directly when the stock market rises. Pension funds that own stock cover about half of all America's families. In addition, over 50 million individual Americans own shares.
- Taxing assets depresses values. From 1968 to 1977, Congress raised capital gains tax rates 75 percent. The Dow Jones Industrial average fell by 40 percent in constant dollars. From 1978 to 1986, when the capital gains tax was cut from 49 percent to 20 percent, the Dow Jones jumped 65 percent in constant dollars.

Spurring High Technology Companies

- Emerging technologies require years of research and development. Young high-tech firms cannot afford to pay dividends in their early years. Instead, they rely on "patient capital" from shareholders who expect stock prices to eventually rise. High capital gains taxes drive otherwise patient investors to demand immediate returns.
- Tax-sensitive individuals outside the professional venture capital industry provide most of the early stage funding to America's small, high-tech companies. For example, in 1985 they provided 59 percent of the \$60-70 billion.
- Most of these entrepreneurial investors, who take chances on risky new projects, are not millionaires. For instance, in 1985 one-third had family incomes under \$60,000, and almost two-thirds had family income under \$100,000.
- High capital gains taxes punish these investors, retarding America's technological growth. Since capital gains tax rates rose in 1987, total venture capital spending has plummeted by about 60 percent.

Unlocking Old Investments for New Investment

- A capital gains tax is a tax on transactions. High rates lead potential sellers to hang onto their assets and buyers to stay on the sidelines. A lower rate will increase sales in all asset markets.
- From 1969 to 1973, the Congress raised the rate in stages from 29 percent to 49 percent. By 1976, real revenues had fallen to 37 percent below 1969 levels.

- Capital gains tax cuts in 1978 and 1982 dramatically increased assets sales and capital gains revenue to the Treasury.
 - o Capital gains realizations soared from \$50.5 billion in 1978 to \$327.6 billion in 1986, when the power of low tax rates to unlock existing gains was forcefully demonstrated.
 - o Tax revenue from capital gains skyrocketed from \$9.1 billion in 1978 to \$49.7 billion in 1986.
 - o The trend collapsed in 1987, after the capital gains tax rate rose again. Capital gains realizations fell to \$144 billion in 1987, while tax revenue fell to \$32.9 billion, down 33.8 percent in one year.
- The Congressional Budget Office substantially overestimated the level of capital gains that would be realized after the tax rate was increased.

Reducing Punitive Taxes on Inflationary Gains

- Capital gains taxes punish American families and businesses, which must pay taxes on illusory gains. High rates depress housing prices and effectively rob Americans.
- Suppose you invest \$1,000 and the value rises \$70 in a year due to a 3 percent (\$30) real gain and a 4 percent (\$40) inflation increase. If you sell the investment and are in the 28 percent tax bracket, you would pay a capital gains tax equal to 28 percent of the total \$70 increase. That's \$19.66 -- a tax of 66 percent of the real gain.
- Suppose you invested \$1,000 in the stock market in 1970 and sold your stocks in 1988. During those eighteen years the Standard and Poors Index rose 219 percent. But inflation was 205 percent. The net gain after inflation would be only \$140. Yet you would pay on the entire 219 percent capital gain. If you were in the 28 percent tax bracket, your effective tax rate on the gain would equal 438 percent.

QUOTATIONS

"The tax on capital gains directly affects...the ease or difficulty experienced by new ventures in obtaining capital, and thereby the strength and potential for growth of the economy."

President John F. Kennedy

"The capital gains differential is a weapon-- a powerful weapon in the battle to be competitive." "That bill [which lowered capital gains tax rates in 1978] did more for the economy of my state than anything I did as a Congressman."

Former Senator Paul Tsongas

"...a reduction in the capital gains tax would be quite helpful. It is especially important considering our current difficulties with weak real estate property values."

Federal Reserve Chairman Alan Greenspan

"A capital gains tax reduction could stimulate growth over the intermediate to long-term, enhancing capital formation and possibly potential output, perhaps helping to permit some extra tax receipts by unlocking unrealized tax gains."

Allen Sinai, Chief Economist, Boston Co. Economic Advisors

"People like me keep harping about eliminating or reducing the capital gains tax and it really could make a difference. It really does influence the cost of capital, and a higher cost of capital really does make us less competitive."

T.J. Rodgers, CEO, Cypress Semiconductor

"I regret that capital gains has been couched as a party issue. John F. Kennedy and Lyndon Johnson advocated a lower capital gains rate, and I find it hard to believe that this has suddenly become a partisan issue...A capital gains tax cut will help lower the cost of capital and help business attract investors and create new jobs."

Congressman J. J. Pickle

INVESTMENT TAX ALLOWANCE (ITA)

The proposal would provide firms an additional first year depreciation equal to 15 percent of the purchase price of newly acquired equipment. This additional depreciation would be allowed for both regular and alternative minimum tax purposes. The property must be acquired on or after February 1, 1992 and before January 1, 1993, and placed in service before July 1, 1993.

Provide Immediate Stimulus for Job-Creating Investment

- The proposal would provide investment incentives by increasing cash flow and by lowering the net cost of capital invested in 1992 for businesses purchasing newly acquired equipment. This would provide a short-term boost to the sluggish recovery, while at the same time raising long-run productivity.
- To create jobs, businesses need to make investments in productive equipment, such as computer-aided design equipment, advanced machine tools, and telecommunications equipment.

Advantages of the ITA Over a Return to the Investment Tax Credit (ITC)

- The President selected the ITA because it benefits all taxpaying businesses, including firms that pay taxes under the Alternative Minimum Tax (AMT). The ITC disadvantages taxpayers subject to the AMT, because its use is limited to 25 percent of AMT liability.
- The ITA reduces effective tax rates by the same percentage for all eligible investment. A five percent ITC favors short-lived assets and has a much higher revenue loss to the Treasury.
- Unlike many ITC proposals, the ITA does not "target" certain forms of equipment and pick winners -- instead, it creates a level playing field for investments.

Improve Corporate Competitiveness

- Companies in the U.S. invest relatively less than their competitors in Germany and Japan. U.S. gross domestic investment as a percent of GNP is the lowest of the six major industrialized countries (Canada, France, Germany, Japan, the U.K., and the U. S.).
- The ITA, along with the reduction in capital gains tax rates and the changes in the Alternative Minimum Tax, will reduce the cost of capital faced by American companies, thereby making them more competitive.

SIMPLIFY AND ENHANCE ALTERNATIVE MINIMUM TAX (AMT) DEPRECIATION

Firms that pay taxes under the AMT currently receive less tax benefit from depreciation than other firms. The President proposes to repeal the "adjusted current earnings" (ACE) depreciation adjustment for firms placing new equipment in service on or after February 1, 1992.

Encourages New Investment Now

- The proposal would target investments in new depreciable property without providing a windfall for prior investments.

Reduces AMT Companies' Cost of Capital

- More than one-third of large U. S. corporations pay income taxes according to the Alternative Minimum Tax rules.
- The current depreciation adjustment used to compute "adjusted current earnings" penalizes capital-intensive companies, such as airlines, chemicals, paper, motor vehicles and steel when they buy equipment to modernize, expand capacity or meet the challenge of international competition.
- This change, along with the reduction in the capital gains tax rate and the Temporary Investment Tax Allowance, would reduce the cost of capital for investing in productive machinery and equipment.
- Capital-intensive industries need reasonable cost recovery policies to stimulate purchases of new equipment and machinery which generate jobs and long-term economic growth.

Benefits Corporate Environmental Improvements

- The proposal also reduces the cost of congressionally mandated pollution control equipment and investments. Previously, tax benefits for pollution control equipment investments were diminished under AMT -- even though the investments produce no income and were mandated by Congress.

Simplifies Current AMT Rules

- The proposal simplifies the AMT by requiring only one computation of depreciation for AMT purposes.

TARGETED JOBS TAX CREDIT

The President proposes to extend the targeted jobs tax credit (TJTC) for one year, through 1993. The TJTC is available on an elective basis for hiring individuals from nine targeted groups, including, among others, economically disadvantaged youths, and Vietnam-era veterans. The credit generally is equal to 40 percent of the first \$6,000 of qualified first-year wages, a maximum credit of \$2,400 per individual.

The TJTC is targeted to benefit economically disadvantaged groups.

- The TJTC is intended to encourage employers willing to hire workers who otherwise may be unable to find employment.
- Workers who may be disadvantaged, such as inner-city youth and Vietnam-era veterans, are among those singled out to benefit from this incentive.

Job creation incentives are required in the current economic climate.

- The incentive is intended to encourage employers to hire workers who otherwise might be unable to find jobs.
- By taking workers off welfare rolls and into private sector jobs, both the individual and society benefit.

ESTABLISH ENTERPRISE ZONES

The President's proposed enterprise zone initiative would supplement existing inducements to invest in economically-distressed areas with additional Federal tax incentives. These incentives -- a limited refundable tax credit for qualified employee wages, elimination of taxation on capital gains attributable to eligible zone property, and limited expensing by individuals for certain capital investments in enterprise zone businesses -- would be offered in conjunction with Federal, State, and local regulatory relief. Up to 50 zones will be selected over a four-year period. The willingness of States and localities to "match" Federal incentives would be considered in selecting the special enterprise zones, and at least one-third of the designated zones would be rural.

The proposal would help economically distressed areas share in the benefits of economic growth.

- Jobs are the best single remedy for the ills of poverty and its related social pathologies.
- Enterprise zones would encourage private industry to invest and create jobs in economically distressed areas through selected tax incentives that reduce the risks and costs of operating or expanding businesses in such areas.

The proposal would introduce a new era of public/private partnerships to help distressed cities and rural areas help themselves.

- The proposal to designate Federal enterprise zones would not replace other long-standing Federal anti-poverty programs. Rather, it would deploy the resources and skills of the private sector toward the Federal anti-poverty effort.

The proposal's focus is on creating new small businesses.

- The reason is simple: firms with 20 or fewer employees generate over two-thirds of all net new private sector jobs. Development of a strong, local business community is an important ingredient in successful revitalization of depressed neighborhoods.
- According to the National Federation of Independent Business, the top priority of the small business community is attracting start-up capital.

Federal tax incentives will enhance the positive results already experienced by State and local enterprise zones.

- Three-fourths of the States are experimenting with enterprise zones, ranging in number from only one to more than 100 zones per state. While these enterprise zones have not had the additional benefit of Federal tax incentives, there is considerable evidence that even the modest tax incentives offered by States and localities had positive results.
- The Department of Housing and Urban Development estimates that state enterprise zones have saved or created a total of 180,000 jobs and spurred about \$9 billion in private investment in poor areas.
- State and local enterprise zones have not yet received Federal tax incentives, which tend to be more valuable to the taxpayer than those that can be offered by State and local governments. The President's enterprise zone proposal will significantly enhance these impressive results.

The tax provisions of the proposal are designed to yield maximum benefits for the cost to the taxpayer.

- The refundable tax credit for qualified employees is designed to encourage low-income inner-city and rural residents to obtain employment, become self-supporting, and leave welfare.
- Expensing of investor purchases of newly-issued corporate stock gives an immediate tax saving to individuals who invest in enterprise zones. It is also designed to provide inner-city entrepreneurs with the seed capital they need to start small businesses.
- A zero capital gains rate for gains on investment in tangible property in the zones is another strong incentive for potential entrepreneurs and outside investors to bring capital into the zone.
- Restricting the incentives to investments in tangible assets, rather than including intangible assets as well, improves the likelihood that benefits would actually accrue to the enterprise zone and not to some other location.

RAISE TAX-FREE MASS TRANSIT BENEFITS THAT EMPLOYERS MAY PROVIDE

The President proposes to increase the amount of tax-free mass transit benefits that employers may provide to employees from \$21 per month to \$60 per month. This proposal underlines the President's commitment to his National Energy Strategy, which presented a comprehensive and balanced approach to meeting this Nation's long-term energy needs.

Increasing Tax-Free Benefits for Mass Transit Addresses Important Energy and Environmental Concerns.

- By encouraging mass transit, this proposal will help reduce traffic congestion, and conserve energy resources.
- Higher mass transit benefits for employees will also discourage commuting by single occupancy vehicles, leading to reductions in urban emissions.

REPEAL EXCISE TAX ON BOATS AND AIRPLANES

The President proposes to repeal the excise tax imposed on boats and aircraft. The revenue loss would be offset by extending the excise tax on diesel fuel sold for use in motorboats.

Repeal of the excise tax for boats and aircraft would reinvigorate industries that employ middle and lower income working Americans.

- This tax penalized the small business owners and workers who sell and service boats and small aircraft. These hard hit industries employ many electricians, carpenters, painters, and other craftsmen.

Offsetting the repeal with an extension of the diesel fuel tax on pleasure boats would not cost jobs in the motorboat industry.

- The burden of extension would be borne primarily by persons who own pleasure boats costing more than \$100,000.

PERMANENT RESEARCH AND EXPERIMENTATION TAX CREDIT

The President proposes to make permanent the 20 percent tax credit for a certain portion of a taxpayer's "qualified research expenses," a credit which would otherwise expire December 31, 1992. In general, qualified expenditures consist of (1) "in-house" expenditures for wages and supplies used in research; (2) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf; and (3) certain time-sharing costs for computers used in research. Current law also provides a separate 20 percent tax credit ("the university basic research credit") for corporate funding of basic research through grants to universities and other qualified organizations.

The proposal would help to generate new jobs.

- Private investment in R&D leads to technological innovations that create new companies that hire more Americans.
- Personal computers, compact discs, biological engineering, and holography are each examples of technologies that in recent years have spawned enormous industries and directly generated tens of thousands of jobs.

The proposal would enhance America's international competitiveness.

- America's long-term position internationally depends upon a strong R&D base.
- Total real industrial R&D expenditures increased significantly from the early 1960s to the mid-1980s, but the rate of growth has levelled off in recent years. The growth of industrial R&D spending dropped from a 7 percent average rate between 1980-1985 to 2 percent between 1985-1990.
- A permanent R&E tax credit would increase corporate R&D spending in the 1990s by about 4 percent, according to studies by Bailey and Lawrence. Making the credit permanent would help reverse the recent trend toward leveling off of corporate R&D spending and enhance the nation's ability to compete in the international environment.

The proposal would encourage productivity gains and higher incomes.

- Extensive research has demonstrated that private sector R&D investments provide a strong stimulus for private productivity.
- As firms become more productive, the real income of workers rises. The R&E tax credit supports the productivity improvements needed to maintain real incomes of American workers at the highest levels in the world.

The proposal would promote improvements in the quality of life for all Americans.

- Private investment in R&D is essential to technological innovation. The quality of life for each of us has been improved immeasurably by the technologies, such as new medicines and machines, that emerge from these investments.
- The R&E tax credit is meant to ensure that the steady flow of new American technologies does not dry up.

The proposal is consistent with the Administration's emphasis on private sector initiative.

- While recognizing the value of direct government funding of research and experimentation, the Administration seeks to encourage private research efforts whenever possible. Private industry is the largest supporter of R&D in the nation, providing about 50 percent of the total national R&D investment.

For maximum effectiveness, the R&E tax credit must be made permanent.

- Stable tax laws that encourage research allow firms to undertake research with greater assurance of the future tax consequences.

PASSIVE LOSS RULES FOR ACTIVE REAL ESTATE DEVELOPERS

The passive loss rules would be amended so that a person's active real estate development operations are treated the same as other businesses', that is, gains and losses can be netted for tax purposes. The proposed amendment would be effective for taxable years ending on or after December 31, 1992.

Passive Loss Loopholes Were Closed in the 1986 Tax Reform

- The 1986 Tax Reform Act intended to close a tax loophole whereby real estate syndicators were forming limited partnerships of money-losing rental properties. These properties were syndicated to non-real estate investors, so-called "passive" investors, for the tax write off.
- However, the reform, as enacted, denied reasonable netting of gains and losses for income tax purposes by full time professional, or "active" developers of real properties.

Help Stop the Slide in Real Estate Values

- With the increase in the tax rate on capital gains, also contained in the 1986 Act, returns on investment of all kinds were lowered, but especially for real estate.
- Lower net returns on investment meant that values of apartments, shopping centers and office buildings began to fall.
- A prudent change in the passive loss rules only for active investors, along with the President's proposal to lower the tax rate on capital gains, will help stabilize real estate prices.

Conform Treatment to Other Businesses

- Because this measure is limited to "active" developers, it will not lead to tax loopholes or encouragement of non-economic construction of unneeded offices or apartments.
- Instead, this proposal will conform the passive loss rules for active real estate investors to the way other businesses operate under the tax rules. For example, corporations net the income and losses from their various subsidiary operations when filing their consolidated income taxes.

Accelerate Real Estate Sales from the RTC

- Along with the reduction in the capital gains tax, this change will help expedite sales of properties from the Resolution Trust Corporation (RTC), increasing the repayment of taxpayer funds in the savings and loan cleanup.
- Likewise, it will help the FDIC and banks market properties that are held in their portfolios. This will reduce the pressure on the FDIC deposit insurance fund.

Improve Bank and Savings & Loan Balance Sheets

- By boosting asset values of their real estate holdings, banks, savings and loans, and insurance companies will benefit through higher values for the properties they own.
- Higher asset values and enhanced sales of assets will boost capital levels of financial institutions.
- Higher capital levels will facilitate greater lending and will help banker and borrower confidence in fighting the "credit crunch."

FACILITATE GREATER PENSION FUND INVESTMENT IN REAL ESTATE

The President proposes four principal changes to tax rules governing the extent to which tax exempt organizations, such as pension funds, are subject to the Unrelated Business Income Tax (UBIT) including: (1) modifying the prohibition on seller-financing to include sales that are made on terms that are commercially reasonable; (2) modifying the sale-leaseback prohibition to permit certain leasebacks to the seller of debt-financed property; (3) permitting investments in certain qualifying partnerships, including repealing the rule which automatically subjects investments in partnerships to UBIT; and, (4) relaxing the prohibition on participating loans in the case of sales of property foreclosed on by financial institutions.

Pension Funds are Traditional Holders of Real Estate Investments

- Along with banks and insurance companies, pension funds are among the largest providers of capital to real estate.
- With nearly \$2 trillion in assets, America's corporate pension funds are a continuing source of long-term investment capital.
- Most of the larger corporate funds have investment allocations in real estate ranging from 5 to 10%, with some funds at higher levels.

Removing Tax Code Impediments to Pension Fund Investing

- The proposals remove impediments to more efficient investing by pension funds in commercial properties.
- These changes lower the transaction costs associated with structuring an investment in the acquisition of a office building, hotel complex, or other long-term investments.

Fights the "Credit Crunch"

- These changes will enhance liquidity in the financial system by facilitating more purchases of properties held by the RTC or other financial institutions, such as banks and insurance companies.
- Greater participation in real estate markets by highly liquid, long-term investors like pension funds will improve prospects for sales and ultimately property values.

HELP FIRST-TIME HOMEBUYERS

Buyers of their first home will be entitled to receive an income tax credit of 10 percent of the purchase price, up to a maximum of \$5,000 spread evenly over tax years 1992 and 1993, on any purchase on or after February 1, 1992 and before January 1, 1993. A "first-time homebuyer" would include any individual not owning a home during the previous three years.

First-time home buyers may also make a penalty free withdrawal from their Individual Retirement Account (IRA) up to a maximum of \$10,000.

Homebuilding in Sluggish Rebound

- Housing starts for single family homes rose very modestly in December, with starts of multi-family units falling 6.1 percent, bringing the annual rate of all starts to 1.090 million units.
- In December, building permits, often an indicator of future housing activity, rose 5.8 percent.
- Responding to the lowest mortgage rates since 1973, sales of existing homes rose 0.9 percent in December.
- Mortgage rates are attracting refinancings, but still not enough new buyers.
- Despite these key indicators showing about a 25% improvement since January 1991, the housing market has been sluggish.

Home Buying Stimulates the Economy

- Combined with the lowest mortgage interest rates since 1973, the President's proposals make now a great time for investing in a home.
- Home construction stimulates jobs -- for builders, carpenters, plumbers, landscapers, architects. The National Association of Homebuilders estimates that a first time home buyer credit of this sort could create over 700,000 jobs, approximately 400,000 added starts, and over 1.0 million additional purchases.
- Home sales spur economic activity through consumer purchases of washers, dryers, refrigerators, and all the services related to buying and moving.

Boost Home Values

- Regions of the country hit hard by weak economic performance, also have had home values fall. 43.7 percent of all Americans' net worth is in their homes.
- These measures, when combined with the President's proposal to reduce capital gains taxes, allow penalty free IRA withdrawal for a first home, and permit deductions for losses on home sales, will boost home equity values and purchases and allow more Americans to own their own home.

PERMIT DEDUCTIBILITY OF LOSSES ON SALE OF PERSONAL RESIDENCES

Capital losses taken by homeowners on the sale of their personal residence would be treated the same as a casualty loss for tax purposes, thus allowing a partial deduction. Losses taken by homeowners on the sale of their personal residence could be carried over in a new home purchased within the two-year rollover period.

Assist Families Forced to Sell in a Bad Market

- These tax changes will help offset any loss resulting from a temporarily bad real estate market. These losses are damaging to those families who have to move and sell their principal residence due to employment or family reasons.

MORTGAGE REVENUE BONDS

The authorization for Mortgage Revenue Bonds is extended for one and one-half years, through December 31, 1993.

Increases Affordable Home Mortgages

- Under this program, the proceeds of certain tax exempt bonds may be used by state and local governments to make loans to low- and moderate-income individuals and families.
- Encourages greater sales of single family homes in the federal government's inventory by facilitating sales linked to state and local government mortgage revenue bonds.

LOW-INCOME HOUSING TAX CREDIT

The President proposes to extend for 18 months State authority to allocate the low-income housing tax credit. The proposal establishes each State's credit allocation authority for 1993 at a level equal to the product of \$1.25 and the State's population. Eligible expenditures include the depreciable costs of new construction and substantial rehabilitations. They also include the cost of acquiring certain existing buildings that have been substantially rehabilitated.

In addition to tenant-based housing vouchers and certificates, the credit is an important mechanism for providing Federal assistance to low-income rental households.

- 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.

The credit is consistent with the Administration's policy that the Government should encourage private provision of housing rather than own and operate housing for low-income citizens itself.

- The private sector can manage privately-owned housing more efficiently than does the Government.
- It is more desirable to foster the private sector to construct low-income housing than to rely on Federal construction and ownership.

FAMILY TAX ALLOWANCE

The President proposes to reduce taxes on working families by increasing the personal exemption for dependent children by \$500 per child, from the current \$2,300. This increase would be indexed for inflation and would be effective as of October 1, 1992. Increasing this exemption will help short-term and long-term economic growth by improving consumer confidence and the ability of families to pay for education, child care, as well as other vital expenses.

Helping the American Family

- Families are the foundation of American society and of the U.S. economy, providing the purchasing power to buy goods, as well as the manpower to produce them. Families buy the homes, automobiles, and appliances that drive American industry forward.
- Tax relief for the family will build consumer and business confidence and permit taxpayers to plan for long-term savings and for major purchases, which will help spark economic recovery.
- Reducing taxes on the family will ease the erosion in the value of the personal exemption for children. In 1948, for example, the exemption was \$600, equal to roughly 20 percent of the median income for two-parent families.

Helping Parents Help Children

- Parents today face enormous financial and social responsibilities. Increasing the personal exemption for children will permit parents to save more for education and to help pay for medical and child care expenses.
- By investing in the family, we foster stability in our neighborhoods. Your future depends not just on your children, but on your neighbors' children, who will be tomorrow's doctors, engineers, and teachers.

FLEXIBLE INDIVIDUAL RETIREMENT ACCOUNTS (FIRAs)

The President proposes to improve current IRAs by establishing a Flexible IRA plan. FIRAs differ from the current-law IRAs in two respects: The contributions are not deductible, but if the contributions are retained in the account for at least seven years, neither the contributions nor the investment earnings are taxed when withdrawn.

Under the proposal, individuals could annually contribute up to \$2,500 to a FIRA, subject to certain income limits, ranging from \$60,000 for single filers to \$120,000 for taxpayers filing joint returns. In addition, individuals may transfer their existing IRA savings to a FIRA before December 31, 1992.

Increases Badly Needed Savings in America

- The United States must save in order to fund necessary investment. Job creating investment is required to raise productivity, which leads to higher standards of living for Americans.
- Savings provide the funds for existing companies that want to expand or for entrepreneurs who have a new idea to develop and market.
- The United States needs to save more both by increasing personal saving rates and by reducing the federal budget deficit, which is a form of dissaving. Flexible IRAs address the first goal, while prudent fiscal restraint addresses the second.
- Current tax laws penalize savings. This proposal along with the balance of the President's program enhances incentives to save and invest.
- The U. S. personal rate of savings in 1991 was 4.3 percent versus 14.5 percent in Japan and 12.8 percent in Germany -- and was below our post-World War II average of 6.8 percent.

Provides Families Greater Flexibility in Savings

- FIRAs serve the additional goal of expanding savings for purposes other than retirement, while not eroding incentives for retirement savings.
- This proposal recognizes that individuals and families save for many reasons including: downpayments on homes, educational expenses, large medical expenses, and as a hedge against uncertain income in the future.

PERMIT DEDUCTION OF INTEREST ON STUDENT LOANS

Interest paid on student loans would be deductible from income taxes.

Helps Families Invest in the Future

- To remain competitive in the international economy, the nation must have a well-educated and well-trained workforce. A deduction for interest costs incurred in financing higher education and training would help to alleviate this problem.
- This deduction assists former, current, and prospective students and their families to cover the cost of undergraduate, graduate or vocational education.
- Many students could not become the doctors or professionals of the next generation without the help of student loans.
- Workers wishing to enter new training courses for a new career would benefit from this change.

EXTEND UNEMPLOYMENT BENEFITS

The President is concerned about Americans who have lost their jobs in the recession and seeks to work with the Congress without delay to ensure that all unemployed Americans receive extended unemployment benefits.

The President proposes legislation to make changes to extend the emergency unemployment compensation program enacted in November, 1991. Simultaneously, the President is working with the bipartisan leadership of congress to pass an unemployment benefits bill as quickly as possible.

Helping the Unemployed Meet Their Needs

Extending unemployment benefits allows individuals and families to continue meeting their basic needs while seeking new jobs.

DEDUCTION FOR SPECIAL-NEEDS ADOPTIONS

The President proposes to permit families to deduct from their income the expenses they face when adopting special-needs children, up to a maximum of \$3,000 per child.

Facilitates Care for Special-Needs Kids

- The proposal enables families with modest financial means to adopt special-needs children.
- The proposal, when combined with the current federal Adoption Assistance Program, would assure that reasonable expenses associated with adopting a special-needs child do not cause financial hardship for the adopting parents.
- This Christmas, an estimated 30,000 children available for adoption spent their holidays waiting for a permanent home. Most of these kids, about 60 percent, are special-needs children.

SMALL ISSUE BONDS FOR FIRST-TIME FARMERS

Under current law, State and local governments are authorized to loan first-time farmers the proceeds of qualified small issue bonds in amounts of up to \$250,000 per farmer, provided that the proceeds are used to acquire qualifying farmland and certain farm-related depreciable property. This authority is scheduled to expire June 30, 1992. The President proposes an extension of the authority, through December 31, 1993.

The proposal encourages innovation in American agriculture.

- Often, first-time farmers are those with the latest ideas and methods acquired in recent training. Assisting their entry into farming will increase innovation in American agriculture in general.

Supports small-scale farmers and helps to preserve an American way of life.

- Farming is a capital-intensive business. Because of the instability of returns, small-scale farmers often have difficulty securing financing, especially those entering the business for the first time. The proposal would help to ease some of these financial barriers to entry.
- Without sufficient financing, new entrants to farming would be less able to acquire the farms of retiring small-scale farmers, who might otherwise have no choice but to sell their properties to large agri-businesses.