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DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

September 15, 1995

MEMORANDUM FOR LEON PANETTA

FROM: LES SAMUELS

SUBJECT: Provisions in the Ways and Means Mark-Up Document

This memorandum briefly describes a number of Chairman Archer's proposals that will be the subject to mark-up in the Ways and Means Committee on Monday afternoon. Treasury will appear at the mark-up. This memorandum includes recommended Administration positions that were discussed at the NEC meeting on September 15, 1995 [certain positions are subject to further discussion].

I. REVENUE RAISERS

A. Pension Asset Reversions. Under current law, an employer must maintain qualified pension assets in trust for the exclusive purpose of providing benefits to employees and generally cannot recover the assets without terminating the plan and paying a substantial excise tax (of up to 50%). A limited exception allows pension plan sponsors to avoid the excise tax if they transfer pension assets that exceed a 25% "cushion" to special accounts dedicated to providing retiree health benefits. The Ways and Means proposal would permit transfer to the employer -- for any purpose -- of pension assets in excess of 125% of a defined benefit plan's "current liability". No excise tax would be imposed on transfers prior to July 1, 1996, and only a 6.5% excise tax would be imposed thereafter.

> **Recommended Administration position: Strongly oppose.** (Alice Rivlin has written to Chairman Archer vigorously criticizing the proposal.) The Retirement Protection Act, passed as part of GATT last December, was a bipartisan effort to improve and strengthen the security of the pension system. Chairman Archer's proposal is a gift to big business that undermines that effort, allowing pension plans to function, in effect, as tax-free corporate savings accounts. Allowing employers to remove pension assets might well lead to a repeat of the large pension raids of the 1980s, when more than $20 billion was taken out of plans through "asset reversions". The proposal also would increase the risk of loss to the pension insurance system. Retention of assets at least equal to 125% of "current liability" could still leave a pension plan underfunded if it is terminated.

B. Repeal of Puerto Rico and Possession Tax Credit (Section 936). The Chairman's Mark generally would repeal section 936 as of the end of 1995. A generous grandfather rule would be provided for existing beneficiaries of the credit ("section 936 companies"). Under the grandfather rule, existing section 936 companies would continue to be eligible for the credit for a period of 10 years, so long as they did not significantly expand their possessions operations. Their possession-source income during the 10-year period, on which the credit is based, would be capped at a base-period level with an inflation adjustment. Limitations on the credit, including an economic activity limitation, were enacted in 1993. However, the proposal would reduce or eliminate the job-creating incentive effect of the 1993 amendments.

> **Recommendation:** **Do not oppose, but only if appropriate programs are in place to assist Puerto Rico.** Section 936 is an inefficient subsidy and should be repealed as a matter of tax policy. The Administration proposed to reformulate the credit in 1993 to make it a more efficient incentive for job creation and economic activity in Puerto Rico; the amendments enacted in 1993 moved part-way toward the Administration's proposals. We believe that section 936, to the extent retained, should provide an incentive for increased economic activity in the possessions rather than merely as an incentive to attribute profits there. If the Committee decides to repeal section 936 with a grandfather of existing beneficiaries, the 10-year cap should be based solely on an economic activity limitation and other programs to assist Puerto Rico should be adopted.

C. **Corporate Owned Life Insurance.** This proposal would deny deductions for interest attributable to the purchase of so-called corporate owned life insurance (COLI) policies. With little out-of-pocket cash required, leveraged COLI products generate offsetting tax-free inside build-up, tax-free death benefits and tax-deductible interest deductions. These policies are frequently bought by corporations to insure large numbers of rank and file employees. The corporation is the beneficiary, however, and the employees frequently do not even know they have been insured. COLI's are primarily a tax-advantaged corporate investment that arbitrages the tax deduction and the tax-free income. The tax subsidy attributable to this arbitrage is so great that some companies agree to borrow at rates well in excess of their market rates.

Many companies claim to have informally dedicated the COLI policies to fund its overall retirement and health benefit obligations. Accordingly, supporters of this provision will claim the proposal will jeopardize such benefits. We believe that the proposal simply eliminates employers' ability to fund these benefits with pre-tax dollars. Companies are still free to fund such obligations through tax advantaged qualified plans or with other investments.

The 1986 Reform Act eliminated the deduction for interest attributable to the purchase of COLI policies with certain exceptions. The COLI products of today take advantage of these exceptions. This bill eliminates the exceptions as of 1996 (even with respect to policies purchased prior to that time). Denying a deduction to purchase tax-free income represents sound tax policy and is consistent with the treatment of the denial of the interest deduction to carry tax-exempt bonds. Nevertheless, insurance brokers are strongly opposed to this proposal.

> **Recommended Administration Position:** **Do not oppose.**

D. **Sunset the low-income housing tax credit after December 31, 1997**. The low-income housing tax credit would sunset after December 31, 1997 to facilitate a review by the House Ways and Means Committee of whether the credit should be modified and/or retained. This decision will be based upon receipt in 1996 of the General Accounting Office report requested by Chairman Archer to review the administration of the credit, with particular emphasis on whether the credit is being improperly claimed and inadequately monitored by the IRS.

> **Recommended Administration Position. Oppose sunset but support GAO study.** The Administration supported the permanent extension of the low income housing tax credit in 1993. It is premature to terminate the credit before the GAO study has been conducted to assess the effectiveness of the program. The IRS has initiated a nationwide audit program to determine compliance with the complex credit provisions, and where fraud is indicated, the IRS has referred cases for criminal prosecution. (A criminal conviction was obtained this summer of a multi-state syndicator.) Scoring this provision as a revenue raiser when the stated purpose is to "facilitate" a future decision as to whether the credit should be modified or retained is a disingenuous revenue raiser.

E. **Termination of Suspense Accounts for Family Corporations Required to Use Accrual Method of Accounting.** Certain closely-held farming corporations required to change from the cash to the accrual method of accounting enjoy a potentially indefinite deferral of the one-time tax liability that would otherwise have been incurred as the result of the change. This deferral is, in effect, an interest-free loan from the Treasury conferred upon these taxpayers as the result of 1987 amendments to the Code.

The bill would prospectively eliminate this deferral for any corporation required to change its method of accounting, and any existing tax deferral would be repaid ratably over a 10-year period (or sooner to the extent provided by existing law). This provision would be effective for taxable years ending after September 13, 1995.

> **Recommended Administration position: Do not oppose.** This deferral is a substantial departure from the policy of the Code and the administrative practices of the Service relating to accounting method changes, in which the cumulative adjustments resulting from such changes are taken into account generally over periods not exceeding six years. Although this provision has been publicly associated with a few well-known companies, available information suggests that there may be many other corporate taxpayers who are currently benefitting from this tax deferral.

F. **Depreciation Under the Income Forecast Method.** Under the "income forecast" method, the cost of motion picture films, video tapes, sound recordings, and other similar property may be depreciated on an accelerated schedule based on projected realization of income from the property. The proposal would modify the method to decelerate the depreciation and thus more accurately match costs of the affected property with expected revenues.

Recommended Administration position: **Do not oppose.** A similar provision was proposed several years ago and was met with strong opposition from affected taxpayers and trade groups, such as the Motion Picture Association of America. We should expect similar opposition this year.

G. Phaseout of Tax Credits for Wind Energy and "Closed Loop" Biomass. The proposal would limit the income tax credit for electricity produced from wind and closed-loop biomass to electricity produced from facilities placed in service before September 14, 1995, with an exception for facilities placed in service before September 14, 1996, pursuant to a binding contract in existence on September 13, 1995. The proposal also provides that the credit would not be available for electricity produced after December 31, 2000. The proposal would be effective for taxable years ending after September 13, 1995.

Recommended Administration position: **[to be discussed].**

H. Remove Business Exclusion for Energy Subsidies Provided by Public Utilities. The proposal would repeal the partial exclusion for any subsidy provided by a utility for the purchase or installation of an energy conservation measure with respect to property that is not a dwelling unit. The provision would be effective for subsidies received after September 13, 1995, unless received pursuant to a binding written contract in effect on that date.

Recommended Administration position: **[to be discussed]**

I. Modify Tax Benefits for Ethanol and Methanol from Renewable Sources.

1. ETBE and similar ethers. The proposal clarifies that ETBE and similar ethers (and alcohol used to produce these ethers) are not eligible for either ethanol or methanol (from renewable sources) tax benefits. The proposal would be effective for fuels produced after December 31, 1995.

2. Limits on eligible production. The proposal provides that the 54-cents-per-gallon (60 cents per gallon for methanol) blender income tax credit for ethanol and methanol from renewable sources, as modified by the proposal, would be available only for alcohol fuels produced by distilling equipment placed in service before September 14, 1995. Additionally, the proposal provides that after September 13, 1995, producers other than small producers (defined as under present law), would only receive benefits on a three-year average annual production amount. The current December 31, 2000, general production sunset for these benefits would be retained.

3. Excise tax "compliance" provisions. The proposal provides that fuel alcohol generally would be subject to the same excise tax rules as gasoline, thereby repealing reduced rates for gasohol, with the addition of a provision allowing alcohol designated as eligible for tax benefits under the revised rules to be sold tax-free. The proposal also provides that the present excise tax alcohol blender refund provisions would be repealed.

4. **Reduce ethanol tax benefits to reflect carbon dioxide by-product value; offset for small producers.** The proposal provides that the 54-cents-per-gallon ethanol income tax credit would be reduced to 51 cents per gallon, to reflect the value of carbon dioxide recovered as a by-product in ethanol production. The proposal also provides that the present-law small ethanol producers credit would be increased from 10 cents per gallon to 13 cents per gallon as an offset. These provisions would be effective on and after January 1, 1996.

Recommended Administration position:

1. **ETBE and similar ethers. [to be discussed].**

2. **Limits on eligible production. [to be discussed].**

3. **Excise tax compliance provisions. [to be discussed].**

4. **Reduce ethanol tax benefits to reflect carbon dioxide by-product value; offset for small producers. [to be discussed].**

J. Tax Gambling Income of Indian Tribes. The proposal would subject to Federal income tax as unrelated business income earned by Indian tribes, from the conduct of certain gaming activities. The Treasury Department would be required to conduct a study on gaming activities conducted by tax-exempt organizations.

Proposed Administration position: **Oppose.** While gaming has become widespread among the Indian tribes, subjecting only one source of revenue is difficult to support on tax policy grounds. Moreover, if Indian tribes are subjected to tax, then all tax-exempt or tax-immune entities conducting these activities should also be taxed. Further, some treaties may be violated by this provision.

K. **Modify exclusion for damages received.** The proposal would limit the current-law exclusion for damages received on account of personal injury or sickness. The proposal would provide that only damages received on account of physical injury or physical sickness would be excludable: no exclusion would apply to damages on account of solely nonphysical injury (such as those related to discrimination or emotional distress) or to any punitive damages received. This proposal would resolve many of the issues that have generated much litigation between the IRS and taxpayers, and would bring the exclusion more in line with modern concepts of income.

Recommended Administration position: [to be discussed].

L. **Expatriation Tax Proposal.** The Chairman's Mark includes H.R. 1812, the "Expatriation Tax Act of 1995," as reported by the House Ways and Means Committee. H.R. 1812 imposes income taxes on certain expatriates on their U.S. source income for a period of ten years, without regard to the motivation for their expatriation. H.R. 1812 generally is intended to override contrary provisions in U.S. tax treaties.

Recommended Administration position: Oppose. H.R. 1812 is an ineffective approach to the problem of tax avoidance through expatriation. Instead, the Administration supports S. 700/H.R. 1535, which treat an expatriating person as having sold his or her assets at fair market value immediately prior to expatriation.

M. **Repeal tax credit for contributions to community development corporations.** OBRA 1993 authorized a 50 percent credit (5 percent per year for 10 years) for certain contributions or long-term loans made to 20 community development corporations (CDCs) to be designated by the Secretary of HUD. Each designated CDC, in turn, could designate up to $2 million in contributions or loans qualifying for the credit (for a total of $40 million in contributions and $20 million in credits). Under this proposal, the credit would be repealed for contributions or loans made after the date of enactment. Contributions made after the date of enactment pursuant to a legally enforceable agreement that was in effect on the date of enactment would remain eligible for the credit.

Recommended Administration position. Oppose.

II. EXTENSIONS OF EXPIRING PROVISIONS

A. **Targeted Jobs Tax Credit.** This proposal would extend the targeted jobs tax credit through December 31, 1997. A credit of 25% against wages up to a maximum wage amount of $6,000 ($3,000 in the case of summer youth) would be allowed for the hiring and retention of certain targeted groups. The targeted groups include AFDC recipients, veterans, ex-felons, high-risk youth residing in empowerment zones and enterprise communities, a vocational rehabilitation referral and summer youth. The provision incorporates certain pre-certification requirements, and employees must be retained for at least 180 days or 500 hours before the credit can be claimed.

Recommended Administration position. Support with modifications. Treasury and Department of Labor have communicated their willingness to work with Congress to establish a credit that is administrable and targeted. The Administration would support extension of the high-risk youth category to youth residing in high poverty areas beyond empowerment zones and enterprise communities and youth who are non-felon offenders, more stringent pre-certification requirements to prevent employer windfall from the credit, and a credit amount large enough to serve as a hiring incentive, while still being with revenue constraints.

B. **Extension of Exclusion for Employer-Provided Educational Assistance Programs.** The proposal would extend section 127, which expired for taxable years beginning after December 31, 1994, three years to December 31, 1997. In addition, the exclusion would not apply to graduate-level courses after 1995.

> **Recommended Administration Position:** **Support** the revenue-neutral extension of the provision because it encourages employers to provide educational assistance. **Oppose** restrictions on graduate level education.

C. **Extension of R&E credit:** Extend retroactively the research and experimentation tax credit for 2½ years (until December 31, 1997), and make minor modification to the definition of "start-up company."

> **Recommended Administration position:** **Support.**

D. **Contributions of Appreciated Stock to Private Foundations.** The proposal would restore the full fair market value deduction for gifts to private foundations of publicly traded stock that can be readily valued. The provision expired on December 31, 1994. Under current law, donors can deduct the full fair market value of publicly traded stock only if they give the stock to a public charity. If they give the stock to a private foundation, their deduction is limited to their basis.

> **Recommended Administration position:** **Support.** Treasury supported this extension -- provided there was sufficient revenue to pay for it -- in testimony submitted to the Subcommittee on Oversight of the House Ways and Means Committee on May 9, 1995.

E. **Credit for Clinical Testing Expenses.** The proposal extends the orphan drug tax credit for the period January 1, 1995, through December 31, 1997.

> **Recommended Administration position:** **Support.** We supported this provision in testimony earlier this year. We also testified that we should consider (i) making the credit permanent so that drug developers could rely on it, and (ii) allowing excess credits to be carried forward to allow smaller drug firms to better take advantage of the credit.

F. **Permanent Extension of FUTA exemption for Alien Agricultural Workers (Section 13106 of bill, Section 3306(c)(1)(B) of Code).** Before January 1, 1995, employment of nonresident aliens who do not intend to abandon their homes outside the U.S. and who are admitted to the United States to work for a temporary period of time to perform agricultural work was not subject to FUTA. This employment is excluded from social security coverage under a permanent provision. The proposal would permanently extend the exclusion from FUTA for years after January 1, 1995.

Recommended Administration Position: [to be discussed].

G. **Delay of scheduled increase in tax on fuel used in commercial aviation.** The effective date of the 4.3-cents-per-gallon tax on commercial aviation fuel would be delayed from October 1, 1995, to October 1, 1997.

Recommended Administration position: [to be discussed]. [***The Administration (Treasury and the Department of Transportation) testified before the Ways and Means and Senate Finance Committees in the summer of 1995 and opposed any delay. The testimony was cleared in the interagency process. Some at the NEC meeting indicated that a delay might be appropriate on political grounds***.] The tax was enacted as part of the Omnibus Budget Reconciliation Act of 1993 (OBRA 93), but the effective date was delayed because of concerns that the commercial airline industry generally was experiencing significant losses. Since 1993, the financial condition of the airline industry has greatly improved and imposition of the tax at this time will be less burdensome than it would have been in 1993. A further delay in the effective date of the tax is unwarranted and would be unfair to other sectors of the transportation industry.

H. **Extension of Airport and Airway Trust Fund excise taxes.** The taxes on air passenger and air freight transportation and the expiring portion of the tax on noncommercial aviation fuel would be extended through September 30, 1996.

Recommended Administration position: Support. These taxes, which support the Airport and Airway Trust Fund, are scheduled to expire on December 31, 1995, and there is a continuing need for revenues from the taxes to support the Trust Fund's programs.

III. Medical Savings Accounts (MSAs)

Under Chairman Archer's proposal, MSAs: (1) Permit an individual tax deduction for contributions to MSAs of up to $2,500 for individuals (or $5,000 for families) who purchase catastrophic health care insurance (defined as coverage with a deductible of at least $1,500, or $3,000 for family coverage) and who, with minor exceptions, have no other health insurance, and

(2) provide, subject to the same limitations, an exclusion from income (and social security wages) for employer contributions to MSAs. Distributions from MSAs could be used to pay for medical care without being taxed, including deductibles under the catastrophic coverage and noncovered services, but not to purchase insurance (other than long-term care insurance). Amounts not used in a year can be carried forward into the next year. Distributions used for nonmedical purposes would be subject to income tax, plus a 10% penalty tax if paid prior to age 59 1/2, death or disability.

<u>Recommended Administration position:</u> **Do not support because health care costs are not yet known and the proposal raises administrative and policy problems.** Although MSAs sound appealing politically, they are very unlikely to have a significant impact on cost containment:

- MSAs, by providing a tax incentive for the purchase of catastrophic insurance, as opposed to comprehensive coverage, would further encourage healthy individuals to leave the insurance risk pool. The remaining participants in the pool would be sicker than average and the costs for those employees would escalate. This separation of winners from losers -- and providing a tax break for the winners -- is truly an example of the Republican philosophy of "survival of the fittest."

- Proponents of MSAs have overstated the amount employers could contribute to employees' MSAs without increasing employer cost. The reduction in premiums when employees switch from comprehensive to catastrophic coverage (the source of employer contributions to MSAs) will typically be less than the increase in the deductible. Therefore, employees with MSAs would be at risk for larger amounts than under current plans, because employers are likely to contribute less than the increase in the deductible. (In an impartial analysis by the American Academy of Actuaries, the mid-range estimate of these reductions in premiums was $1,562 per family for an employer that switched from a plan with a $200 deductible to a plan with a $3,000 deductible for all its employees.) Because of adverse selection, if employers offered employees a choice between the plans, employers could not hold their costs constant, without further reducing their MSA contributions.

IV. OTHER PROPOSALS

A. <u>Repeal of Excess Passive Assets Provision (Section 956A).</u> The Chairman's Mark would repeal section 956A, which Treasury proposed and Congress enacted in 1993. Under section 956A, a U.S. shareholder of a controlled foreign corporation ("CFC") is subject to current U.S. tax on the CFC's earnings that are invested in an excessive amount of passive foreign assets. Passive investments are considered "excessive" if they exceed 25 percent of the CFC's total assets. Prior to enactment of section 956A, taxpayers generally enjoyed unlimited deferral of U.S. tax on foreign earnings as long as the earnings were not repatriated. Taxpayers responded to the incentive provided by the opportunity for unlimited deferral by retaining foreign earnings in passive foreign assets. Our data indicated that, on average, passive assets held by CFCs in tax havens represented approximately 30 percent of total assets, whereas passive assets held by CFCs in other foreign countries represented only 7 percent of total assets. This indicates that the 25-percent threshold generously accommodates working capital needs and that accumulations in excess of 25 percent reflect tax rather than business considerations. Section 956A reduces the incentive to locate business abroad and to retain the resulting earnings in passive investments.

Recommended Administration position: **Oppose.**

B. **Earned Income Tax Credit.** The Chairman's Mark includes proposals that are expected to reduce the EITC by more than $20 billion over seven years.

Recommended Administrative Position. **Oppose**. We strongly oppose this tax increase on working Americans eligible for the EITC.

DEPARTMENT OF THE TREASURY
OFFICE OF TAX POLICY
TAX LEGISLATIVE COUNSEL

1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

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TO: Sec. Rubin
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FROM: *Glen A. Kohl*, Tax Legislative Counsel | 202/622-0140
FOR LES SAMUELS
Name | Confirmation number

Sender's FAX number: 202/622-0605 Location: Room 3064MT

Comments/Special Instructions: ______

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<u>**Recommendation:**</u> **Do not oppose, but only if appropriate programs are in place to assist Puerto Rico.** Section 936 is an inefficient subsidy and should be repealed as a matter of tax policy. The Administration proposed to reformulate the credit in 1993 to make it a more efficient incentive for job creation and economic activity in Puerto Rico; the amendments enacted in 1993 moved part-way toward the Administration's proposals. We believe that section 936, to the extent retained, should provide an incentive for increased economic activity in the possessions rather than merely as an incentive to attribute profits there. If the Committee decides to repeal section 936 with a grandfather of existing beneficiaries, the 10-year cap should be based solely on an economic activity limitation and other programs to assist Puerto Rico should be adopted.

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4. **Reduce ethanol tax benefits to reflect carbon dioxide by-product value; offset for small producers. [to be discussed].**

J. Tax Gambling Income of Indian Tribes. The proposal would subject to Federal income tax as unrelated business income earned by Indian tribes, from the conduct of certain gaming activities. The Treasury Department would be required to conduct a study on gaming activities conducted by tax-exempt organizations.

Proposed Administration position: **Oppose.** While gaming has become widespread among the Indian tribes, subjecting only one source of revenue is difficult to support on tax policy grounds. Moreover, if Indian tribes are subjected to tax, then all tax-exempt or tax-immune entities conducting these activities should also be taxed. Further, some treaties may be violated by this provision.

K. Modify exclusion for damages received. The proposal would limit the current-law exclusion for damages received on account of personal injury or sickness. The proposal would provide that only damages received on account of physical injury or physical sickness would be excludable: no exclusion would apply to damages on account of solely nonphysical injury (such as those related to discrimination or emotional distress) or to any punitive damages received. This proposal would resolve many of the issues that have generated much litigation between the IRS and taxpayers, and would bring the exclusion more in line with modern concepts of income.

Recommended Administration position: [to be discussed].

L. **Expatriation Tax Proposal.** The Chairman's Mark includes H.R. 1812, the "Expatriation Tax Act of 1995," as reported by the House Ways and Means Committee. H.R. 1812 imposes income taxes on certain expatriates on their U.S. source income for a period of ten years, without regard to the motivation for their expatriation. H.R. 1812 generally is intended to override contrary provisions in U.S. tax treaties.

Recommended Administration position: **Oppose.** H.R. 1812 is an ineffective approach to the problem of tax avoidance through expatriation. Instead, the Administration supports S. 700/H.R. 1535, which treat an expatriating person as having sold his or her assets at fair market value immediately prior to expatriation.

M. **Repeal tax credit for contributions to community development corporations.** OBRA 1993 authorized a 50 percent credit (5 percent per year for 10 years) for certain contributions or long-term loans made to 20 community development corporations (CDCs) to be designated by the Secretary of HUD. Each designated CDC, in turn, could designate up to $2 million in contributions or loans qualifying for the credit (for a total of $40 million in contributions and $20 million in credits). Under this proposal, the credit would be repealed for contributions or loans made after the date of enactment. Contributions made after the date of enactment pursuant to a legally enforceable agreement that was in effect on the date of enactment would remain eligible for the credit.

Recommended Administration position. **Oppose.**

II. EXTENSIONS OF EXPIRING PROVISIONS

A. **Targeted Jobs Tax Credit.** This proposal would extend the targeted jobs tax credit through December 31, 1997. A credit of 25% against wages up to a maximum wage amount of $6,000 ($3,000 in the case of summer youth) would be allowed for the hiring and retention of certain targeted groups. The targeted groups include AFDC recipients, veterans, ex-felons, high-risk youth residing in empowerment zones and enterprise communities, a vocational rehabilitation referral and summer youth. The provision incorporates certain pre-certification requirements, and employees must be retained for at least 180 days or 500 hours before the credit can be claimed.

Recommended Administration position. **Support with modifications.** Treasury and Department of Labor have commmicated their willingness to work with Congress to establish a credit that is administrable and targeted. The Administration would support extension of the high-risk youth category to youth residing in high poverty areas beyond empowerment zones and enterprise communities and youth who are non-felon offenders, more stringent pre-certification requirements to prevent employer windfall from the credit, and a credit amount large enough to serve as a hiring incentive, while still being with revenue constraints.

B. **Extension of Exclusion for Employer-Provided Educational Assistance Programs.** The proposal would extend section 127, which expired for taxable years beginning after December 31, 1994, three years to December 31, 1997. In addition, the exclusion would not apply to graduate-level courses after 1995.

Recommended Administration Position: **Support** the revenue-neutral extension of the provision because it encourages employers to provide educational assistance. **Oppose** restrictions on graduate level education.

C. **Extension of R&E credit:** Extend retroactively the research and experimentation tax credit for 2½ years (until December 31, 1997), and make minor modification to the definition of "start-up company."

Recommended Administration position: **Support.**

D. **Contributions of Appreciated Stock to Private Foundations.** The proposal would restore the full fair market value deduction for gifts to private foundations of publicly traded stock that can be readily valued. The provision expired on December 31, 1994. Under current law, donors can deduct the full fair market value of publicly traded stock only if they give the stock to a public charity. If they give the stock to a private foundation, their deduction is limited to their basis.

Recommended Administration position: **Support.** Treasury supported this extension -- provided there was sufficient revenue to pay for it -- in testimony submitted to the Subcommittee on Oversight of the House Ways and Means Committee on May 9, 1995.

E. **Credit for Clinical Testing Expenses.** The proposal extends the orphan drug tax credit for the period January 1, 1995, through December 31, 1997.

Recommended Administration position: **Support.** We supported this provision in testimony earlier this year. We also testified that we should consider (i) making the credit permanent so that drug developers could rely on it, and (ii) allowing excess credits to be carried forward to allow smaller drug firms to better take advantage of the credit.

F. <u>Permanent Extension of FUTA exemption for Alien Agricultural Workers (Section 13106 of bill, Section 3306(c)(1)(B) of Code).</u> Before January 1, 1995, employment of nonresident aliens who do not intend to abandon their homes outside the U.S. and who are admitted to the United States to work for a temporary period of time to perform agricultural work was not subject to FUTA. This employment is excluded from social security coverage under a permanent provision. The proposal would permanently extend the exclusion from FUTA for years after January 1, 1995.

<u>Recommended Administration Position:</u> [to be discussed].

G. <u>Delay of scheduled increase in tax on fuel used in commercial aviation.</u> The effective date of the 4.3-cents-per-gallon tax on commercial aviation fuel would be delayed from October 1, 1995, to October 1, 1997.

<u>Recommended Administration position:</u> [to be discussed]. [***The Administration (Treasury and the Department of Transportation) testified before the Ways and Means and Senate Finance Committees in the summer of 1995 and opposed any delay. The testimony was cleared in the interagency process. Some at the NEC meeting indicated that a delay might be appropriate on political grounds.***] The tax was enacted as part of the Omnibus Budget Reconciliation Act of 1993, (OBRA 93), but the effective date was delayed because of concerns that the commercial airline industry generally was experiencing significant losses. Since 1993, the financial condition of the airline industry has greatly improved and imposition of the tax at this time will be less burdensome than it would have been in 1993. A further delay in the effective date of the tax is unwarranted and would be unfair to other sectors of the transportation industry.

H. <u>Extension of Airport and Airway Trust Fund excise taxes.</u> The taxes on air passenger and air freight transportation and the expiring portion of the tax on noncommercial aviation fuel would be extended through September 30, 1996.

<u>Recommended Administration position:</u> Support. These taxes, which support the Airport and Airway Trust Fund, are scheduled to expire on December 31, 1995, and there is a continuing need for revenues from the taxes to support the Trust Fund's programs.

III. <u>Medical Savings Accounts (MSAs)</u>

Under Chairman Archer's proposal, MSAs: (1) Permit an individual tax deduction for contributions to MSAs of up to $2,500 for individuals (or $5,000 for families) who purchase catastrophic health care insurance (defined as coverage with a deductible of at least $1,500, or $3,000 for family coverage) and who, with minor exceptions, have no other health insurance, and

(2) provide, subject to the same limitations, an exclusion from income (and social security wages) for employer contributions to MSAs. Distributions from MSAs could be used to pay for medical care without being taxed, including deductibles under the catastrophic coverage and noncovered services, but not to purchase insurance (other than long-term care insurance). Amounts not used in a year can be carried forward into the next year. Distributions used for nonmedical purposes would be subject to income tax, plus a 10% penalty tax if paid prior to age 59 1/2, death or disability.

<u>Recommended Administration position:</u> **Do not support because health care costs are not yet known and the proposal raises administrative and policy problems.** Although MSAs sound appealing politically, they are very unlikely to have a significant impact on cost containment:

- MSAs, by providing a tax incentive for the purchase of catastrophic insurance, as opposed to comprehensive coverage, would further encourage healthy individuals to leave the insurance risk pool. The remaining participants in the pool would be sicker than average and the costs for those employees would escalate. This separation of winners from losers -- and providing a tax break for the winners -- is truly an example of the Republican philosophy of "survival of the fittest."

- Proponents of MSAs have overstated the amount employers could contribute to employees' MSAs without increasing employer cost. The reduction in premiums when employees switch from comprehensive to catastrophic coverage (the source of employer contributions to MSAs) will typically be less than the increase in the deductible. Therefore, employees with MSAs would be at risk for larger amounts than under current plans, because employers are likely to contribute less than the increase in the deductible. (In an impartial analysis by the American Academy of Actuaries, the mid-range estimate of these reductions in premiums was $1,562 per family for an employer that switched from a plan with a $200 deductible to a plan with a $3,000 deductible for all its employees.) Because of adverse selection, if employers offered employees a choice between the plans, employers could not hold their costs constant, without further reducing their MSA contributions.

IV. OTHER PROPOSALS

A. <u>Repeal of Excess Passive Assets Provision (Section 956A).</u> The Chairman's Mark would repeal section 956A, which Treasury proposed and Congress enacted in 1993. Under section 956A, a U.S. shareholder of a controlled foreign corporation ("CFC") is subject to current U.S. tax on the CFC's earnings that are invested in an excessive amount of passive foreign assets. Passive investments are considered "excessive" if they exceed 25 percent of the CFC's total assets. Prior to enactment of section 956A, taxpayers generally enjoyed unlimited deferral of U.S. tax on foreign earnings as long as the earnings were not repatriated. Taxpayers responded to the incentive provided by the opportunity for unlimited deferral by retaining foreign earnings in passive foreign assets. Our data indicated that, on average, passive assets held by CFCs in tax havens represented approximately 30 percent of total assets, whereas passive assets held by CFCs in other foreign countries represented only 7 percent of total assets. This indicates that the 25-percent threshold generously accommodates working capital needs and that accumulations in excess of 25 percent reflect tax rather than business considerations. Section 956A reduces the incentive to locate business abroad and to retain the resulting earnings in passive investments.

Recommended Administration position: **Oppose.**

B. **Earned Income Tax Credit.** The Chairman's Mark includes proposals that are expected to reduce the EITC by more than $20 billion over seven years.

Recommended Administrative Position. Oppose. We strongly oppose this tax increase on working Americans eligible for the EITC.