[JOINT COMMITTEE PRINT]

TAX REFORM PROPOSALS IN CONNECTION WITH COMMITTEE ON WAYS AND MEANS MARKUP

Prepared by the Staff
of the
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INTRODUCTION

This document [1] provides a summary description of tax reform proposals in connection with the markup by the Committee on Ways and Means, beginning on September 26, 1985.

The document, in columnar form for each item, includes present law (Col. 2), the President's tax reform proposal (Col. 3), and a possible option (Col. 4).

Part I describes individual income tax provisions. Part II describes provisions relating to the tax treatment of capital income. Part III describes corporate tax provisions and ESOPs. Part IV describes tax shelter-related provisions. Part V describes minimum tax provisions. Part VI describes foreign-related tax provisions. Part VII describes provisions related to tax-exempt bonds. Part VIII describes provisions relating to the taxation of financial institutions. Part IX describes accounting-related tax provisions. Part X describes tax provisions relating to insurance products and companies. Part XI describes pensions and deferred compensation and fringe benefits. Part XII describes income taxation of trusts and estates and the generation-skipping transfer tax. Finally, Part XIII describes provisions relating to taxpayer compliance and tax administration.

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I. INDIVIDUAL INCOME TAX PROVISIONS

Item	Present Law	President's Proposal	Possible Option
. Basic Rate Structure			
1. Tax rate schedules	There are four filing status classifications, each with a different 1986 schedule of tax rates and taxable income brackets. Indexing of bracket amounts began in 1985. The following figures are expected to be in effect on January 1, 1986, and reflect an assumed 3.7% inflation rate in 1985.	The tax structure would consist of three taxable income brackets and tax rates—15, 25, and 35 percent—above the zero bracket amount. Indexing would be continued as under present law.	Same as President's proposal, except for modifications shown below.
a. Married individuals filing jointly and surviving spouse	14 taxable income brackets above the zero bracket amount of $3,670; 11-percent tax rate starts above $3,670; rates rise to the maximum 50-percent rate above $175,230.	*Tax rate* — *Brackets ($)* ZBA — 0 to 4,000 15% — 4,000 to 29,000 25% — 29,000 to 70,000 35% — Over 70,000	*Tax rate* — *Brackets ($)* ZBA — replaced by standard deduction 15% — 0 to 27,300 25% — 27,300 to 62,300 35% — Over 62,300
b. Head of household	14 taxable income brackets above the $2,480 zero bracket amount; 11-percent tax rate starts above $2,480; rates rise to the 50-percent rate above $116,850.	*Tax rate* — *Brackets ($)* ZBA — 0 to 3,600 15% — 3,600 to 23,000 25% — 23,000 to 52,000 35% — Over 52,000	*Tax rate* — *Brackets ($)* ZBA — replaced by standard deduction 15% — 0 to 19,400 25% — 19,400 to 48,400 35% — Over 48,400
c. Unmarried individuals	15 taxable income brackets above the $2,480 zero bracket amount; 11-percent tax rate starts above $2,480; rates rise to the 50-percent rate above $88,260.	*Tax rate* — *Brackets ($)* ZBA — 0 to 2,900 15% — 2,900 to 18,000 25% — 18,000 to 42,000 35% — Over 42,000 *Effective date.*—The changed tax rates and taxable income brackets would become effective on July 1, 1986. For taxable year 1986, tax rate schedules would have to blend the estimated present law schedules with the proposed 3-step schedules.	*Tax rate* — *Brackets ($)* ZBA — replaced by standard deduction 15% — 0 to 14,100 25% — 14,100 to 39,100 35% — Over 39,100 *Effective date.*—The new tax rates and tax brackets would become effective on January 1, 1986.
2. Zero bracket amount	ZBA differs by taxpayer filing status and has been indexed annually for changes in the inflation rate since January 1, 1985. Estimated ZBAs (below) effective January 1, 1986, reflect an assumed 3.7 percent inflation adjustment. *Filing status* — *ZBA* Joint returns and surviving spouse — $3,670 Heads of household — 2,480 Unmarried individuals — 2,480	*Filing status* — *ZBA* Joint returns and surviving spouse — $4,000 Heads of household — 3,600 Unmarried individuals — 2,900	Instead of the ZBA, each taxpayer would be allowed a standard deduction: *Filing status* — *Standard deduction* Joint returns and surviving spouse — $6,000 (in 1986 — 4,700) Heads of households — 4,275 (in 1986 — 3,200) Unmarried individuals — 3,550 (in 1986 — 3,000)

Item	Present Law	President's Proposal	Possible Option
		Indexing would continue as in present law.	The standard deduction allowed to each filing status would be increased by $500 for each dependent, and by $500 for individuals 65 years or older, and for the blind. Indexing would continue, and would increase all scheduled amounts beginning in 1988.
3. Personal exemptions	The personal exemption for an individual, the individual's spouse, and each dependent is $1,040 for 1985. One additional personal exemption is provided for an individual who is age 65 or older, and for an individual who is blind. Indexing is expected to increase the personal exemption for 1986 to $1,080.	The personal exemption for an individual, an individual's spouse, and each dependent would increase to $2,000. The additional exemption for elderly or blind individuals would be repealed. Indexing would be continued as under present law. *Effective date.*—The changes in the zero bracket amount and the personal exemption would become effective on January 1, 1986.	Same as President's proposal, except that the personal exemption would be increased to $1,500 (this results from moving $500 of the proposed increase in personal exemption amounts into the standard deduction). *Effective date.*—The new standard deduction and personal exemptions would become effective on January 1, 1986.
4. Two-earner deduction	Under present law, differing rate schedules and zero bracket amounts contribute to an increased tax liability (marriage penalty) when two single taxpayers marry and file a joint return. Couples filing a joint return are allowed a tax deduction equal to 10 percent of the lesser of the earned income of the lower-earning spouse or $30,000. The maximum deduction, therefore, is $3,000.	Would repeal the two-earner deduction. *Effective date.*—The provision would be effective for taxable years beginning on or after January 1, 1986.	Same as President's proposal (marriage penalty relief provided through standard deduction and rate schedules).
5. Earned income credit	Taxpayers with one or more children are allowed a credit of 11 percent of their first $5,000 of earned income (maximum credit of $550). The amount of the credit is reduced as income rises over $6,500, and the credit is totally phased-out at $11,000 of AGI.	Increase the allowable credit to 14 percent of the first $5,000 of earned income (maximum credit of $700). The income level at which the phaseout begins would be raised to $6,500 with a total phaseout at $13,500 of AGI. The maximum amount of the credit as well as the phaseout income levels would be adjusted for inflation occurring after 1984. *Effective date.*—The provision would be effective for taxable years beginning on or after January 1, 1986.	Same as President's proposal, except that, for taxable years beginning on or after January 1, 1987, the income level at which the phaseout begins would be increased to $9,000. Because the rate of phaseout is the same as President's proposal, total phaseout does not occur until $16,000 of AGI.

Item	Present Law	President's Proposal	Possible Option
6. Child and dependent care expenses			
a. Child care credit	A nonrefundable credit against income tax liability is available for up to 30 percent of a limited dollar amount of employment-related child and dependent care expenses for a child or other dependent who is under the age of 15, a physically or mentally incapacitated dependent, or a physically or mentally incapacitated spouse. Eligible employment-related expenses are limited to $2,400 if there is one qualifying individual, and $4,800 if there are two or more qualifying individuals, but cannot exceed the earned income of the individual or of the lesser earning spouse (in the case of married taxpayers). The 30-percent credit rate is reduced by one percentage point for each $2,000 (or fraction thereof) of AGI above $10,000, but not below 20 percent for AGI above $28,000.	Retain present law.	Same as the President's proposal, but raise the limitation on eligible employment-related expenses to $2,450 (for one qualifying individual) and $4,900 (for two or more qualifying individuals), effective for taxable years beginning after December 31, 1985.
b. Dependent care assistance exclusion	Present law excludes from an employee's gross income amounts paid or incurred by an employer for dependent care assistance provided under a qualified dependent care assistance program. The exclusion generally is available under conditions similar to the child care credit, but is not subject to a limit on the amount excludable. No exclusion is available unless the dependent care assistance program meets certain nondiscrimination requirements.	Retain present law.	Repeal the exclusion, effective for taxable years beginning after December 31, 1985.
7. Income averaging	An eligible individual (i.e., one who has been self-supporting and a U.S. citizen or resident during the past 3 years) can elect to have a lower marginal rate apply to the portion of income that is more than 40 percent higher than his or her average income for the prior 3 years.	Income averaging would be repealed. *Effective date.*—Taxable years beginning after 1985.	Same as the President's proposal.

Item	Present Law	President's Proposal	Possible Option
. Tax Treatment of the Elderly and Disabled			
1. Personal exemptions	Present law provides an additional personal exemption ($1,080 for 1986) for an individual who is age 65 or older, or who is blind. An individual who is both age 65 or over and blind is entitled to claim two additional personal exemptions.	The President's proposal would repeal the additional personal exemption for an individual age 65 or over, and would repeal the additional personal exemption for an individual who is blind. *Effective date.*—The proposal would be effective for taxable years beginning after December 31, 1985.	Follow the President's proposal, but provide that the standard deduction would be increased by $500 for an individual over age 65, and by $500 for a blind individual. The standard deduction would be increased by $1,000 in the case of an individual who is both elderly and blind. *Effective date.*—Same as the President's proposal.
2. Credit for the elderly	Present law provides a nonrefundable income tax credit for individuals who are age 65 or over, or who have retired on permanent and total disability. The credit equals 15 percent of an initial base amount reduced by the amount of certain tax-free income received by the taxpayer and by one-half of the taxpayer's AGI exceeding a specified threshold. The initial base amount is $5,000 for an unmarried individual or for a married couple filing a joint return if only one spouse is eligible for the credit; $7,500 for a married couple filing a joint return with both spouses eligible for the credit; or $3,750 for a married couple filing separate returns. For a disabled individual who is under age 65, however, the initial base amount equals the individual's disability income for the year, if less than the initial base amount. The initial base amount is reduced by certain nontaxable income of the taxpayer, including pension and annuity income, social security, railroad retirement, or veterans' nonservice-related disability benefits. In addition, the initial base amount is reduced by one-half of the taxpayer's AGI in excess of $7,500, in the case of a single individual; $10,000, in the case of married taxpayers filing a joint return; or $5,000, in the case of married taxpayers filing separate returns.	Under the President's proposal, the tax credit for the elderly and disabled would be expanded and modified as follows: (1) The class of taxpayers eligible for the credit would be expanded to include taxpayers under age 65 who (a) are blind, or (b) receive workers' compensation or black lung disability benefits. (2) The initial base amount on which the credit is calculated would be increased to $7,000, in the case of an eligible single individual or a married couple filing a joint return with only one spouse eligible for the expanded credit; $9,250, in the case of a head of household; and $11,500, in the case of a married couple filing a joint return where both spouses are eligible for the credit ($5,750, in the case of such a married couple filing separate returns). In addition, the initial base amount for an individual who is both elderly and blind would be increased by $1,500. (3) The AGI level at which the initial base amount begins to be reduced would be increased to $11,000, in the case of an unmarried individual; $12,500, in the case of a head of household; and $14,000, in the case of a married couple filing a joint return ($7,000, in the case of a married couple filing separate returns).	Retain present law.

Item	Present Law	President's Proposal	Possible Option
2. Credit for the elderly (Cont.)		(4) All dollar amounts used in determining the amount of the credit would be indexed for inflation in future years. (5) For those taxpayers with workers' compensation and black lung disability benefits, the initial base amount would be the sum of (a) the amount of such benefits received, and (b) any initial base amount for which they would otherwise qualify. Under the proposal, other disability income eligible for the credit would be restricted to disability payments from a "qualified plan." *Effective date.*—The proposal would be effective for taxable years beginning after December 31, 1985.	
3, Wage replacement benefits *a. Unemployment compensation*	Present law provides a limited exclusion from income for unemployment compensation benefits received under a Federal or State program. If the sum of the taxpayer's unemployment compensation benefits and AGI does not exceed a base amount, then the entire benefit is excluded from income. The base amount is $12,000, in the case of an unmarried individual; $18,000, in the case of a married couple filing a joint return; and zero, in the case of a married couple filing separate returns. If the base amount is exceeded, then the amount of unemployment compensation benefits that is includible in income is equal to the lesser of (1) one-half of the combined income (modified AGI plus benefits) over the base amount, or (2) the amount of the unemployment compensation.	Under the President's proposal, all unemployment compensation would be includible in gross income. *Effective date.*—The proposal would be effective for taxable years beginning after December 31, 1986.	Same as the President's proposal.

Item	Present Law	President's Proposal	Possible Option
b. Workers' compensation and black lung disability benefits	Present law provides that gross income does not include amounts received under workers' compensation Acts as compensation for personal injuries or sickness. This exclusion also applies to benefits paid under a workers' compensation act to a survivor of a deceased employee. Under present law, black lung disability benefits paid for claims by coal miners are excludable from gross income as workers' compensation benefits.	Under the President's proposal, all cash payments for workers' compensation and black lung disability benefits would be includible in gross income, except for payments for medical services (unless previously deducted), payments for physical and vocational rehabilitation, and payments for burial expenses. Worker's compensation and black lung disability benefits would be eligible for the expanded credit for the elderly. *Effective date.*—The repeal of the exclusion for workers' compensation benefits would apply to benefits attributable to disabilities occurring on or after January 1, 1987. The provision that would make workers' compensation and black lung disability benefits eligible for the expanded credit for the elderly would be effective for taxable years beginning after December 31, 1986.	Follow President's proposal, but provide a limited exclusion from income for workers' compensation and black lung disability benefits instead of making such benefits eligible for the credit for the elderly. Under the modification, such benefits would continue to be excluded from gross income if the taxpayer's AGI (not including workers' compensation or black lung disability benefits) does not exceed $15,000, in the case of a single individual; $20,000, in the case of a married couple filing a joint return; and zero, in the case of a married couple filing separate returns. If AGI exceeds the base amount, then the amount of the benefit includible in gross income would be equal to the lesser of (a) one-half of the taxpayer's AGI over the base amount or (b) the amount of the workers' compensation or black lung disability benefits. An employer would be required to report to the IRS and to the recipient the amount of benefits received. *Effective date.*—Same as the President's proposal.
c. Other employer-provided disability benefits	Under present law, gross income does not include amounts received under an employer-provided accident and health plan to the extent the amounts (1) constitute payment for the permanent loss or loss of use of a member or function of the body, or the permanent disfigurement, of the employee (or the employee's spouse or dependent), and (2) are computed with reference to the nature of the injury without regard to the period the employee is absent from work.	Retain present law.	Repeal present-law exclusion, and include such amounts in the formula for taxation of workers' compensation and black lung disability. An employer would be required to report to the IRS and to the employee the amount of disability benefits paid. *Effective date.*—The proposal would be effective for taxable years beginning after December 31, 1986.

Item	Present Law	President's Proposal	Possible Option
. Exclusions for Scholarships, Prizes, and Awards 1. Scholarships and fellowships	Degree candidates at an educational institution may exclude amounts received as a scholarship or fellowship grant, and also incidental amounts for expenses for travel, research, clerical help, and equipment. Nondegree candidates may exclude only scholarships or fellowship grants from tax-exempt organizations or international or governmental agencies, limited to a maximum lifetime exclusion of $10,800. The exclusion for incidental amounts received by nondegree candidates is not limited.	Amounts received as scholarships and fellowship grants by degree candidates would be excludable only to the extent that they were required to be, and were, spent on tuition and equipment required for courses of instruction. Nondegree candidates would not be permitted to exclude any such amounts, but could exclude reimbursements for incidental expenses (travel, research, clerical help, or equipment). Degree candidates would not be permitted to exclude incidental expenses.	Same as the President's proposal except that incidental expenses of nondegree candidates would not be eligible for the exclusion, to eliminate redundancy with deduction for business expenses.
	Amounts received by degree candidates are not eligible for the exclusion if they represent payment for teaching or other services required as a condition of receiving the grant, unless all candidates for a particular degree must perform such services.	The special rule concerning future performance of services would be repealed.	Same as the President's proposal.
	Grants received under a Federal program which would otherwise be eligible for the exclusion but for the fact that the recipient must perform future services as a Federal employee, are excludable to the extent used for tuition and required fees, books, supplies, and equipment.	This special rule relating to certain Federal grants would be repealed. *Effective date.*—The proposal would be effective for scholarships and fellowships received in taxable years beginning on or after January 1, 1986, except that if a binding commitment to grant a scholarship for a degree candidate is made before January 1, 1986, amounts received would be excludable under present law through 1990.	Same as President's proposal. *Effective date.*—The proposal would be effective for scholarships and fellowships granted after September 25, 1985.
2. Prizes and awards	Prizes and awards received by the taxpayer, other than certain scholarships and fellowship grants, generally are taxable. However, there is an exception for awards received for achievements in fields such as charity, the arts, and the sciences, applying only if the recipient (i) has not specifically applied for the prize or award (e.g., by entering a contest), and (ii) is not required substantial services as a condition of receiving it.	All prizes and awards (other than certain scholarships and fellowship grants) would be taxable. The present exclusion for awards for charitable, etc. achievement would apply only when the recipient designated that the prize or award go to a tax-exempt charitable organization.	Same as President's proposal.
	Gifts are excludable from the income of recipients. To qualify as a gift, an item must be given out of detached generosity and not as compensation or to benefit the donor. Business deductions for gifts are generally limited to $25 per recipient. However, for an employee award given by reason of length of service, productivity, or safety achievement that qualifies as a gift and as deductible, the deduction is limited to $400 or $1,600 (depending on the circumstances).	Gift treatment would be denied for all employee awards given by reason of a work-related achievement. Since no employee awards would be both excludable and deductible, the deduction limits under present law would have no application. *Effective date.*—Taxable years beginning after 1985.	Same as President's proposal, with clarification that employee awards of low value may qualify as both deductible and excludable under the rules for de minimis fringe benefits, enacted in 1984 (sec. 132).

Item	Present Law	President's Proposal	Possible Option
Deductions for Personal Expenditures **1. Itemized deduction for certain State and local taxes**	Individuals may claim itemized deductions with respect to the following State and local taxes: income taxes, real property taxes, personal property taxes, and sales taxes. No other State and local taxes are deductible by individuals unless incurred in a business or in an income-producing (investment) activity.	The itemized deduction for State and local taxes would be repealed. State and local taxes other than income taxes would be deductible if incurred in a business or, subject to the limitation in the following sentence, in an investment activity. When incurred by an individual in an investment activity, these taxes would be among the category of expenditures that would be deductible "above-the-line" to the extent exceeding one percent of adjusted gross income (see item E.2, below). *Effective date.*—Taxable years beginning after 1985.	The itemized deduction for State and local sales taxes and personal property taxes would be repealed. For income and real property taxes only, an itemized deduction would be allowed for the *greater* of (i) $1,000 ($500 for unmarried individuals), or (ii) the amount of such taxes exceeding 5 percent of the individual's adjusted gross income. State and local sales and personal property taxes, when incurred in a business or investment activity, would be capitalized when appropriate; otherwise, such taxes would be deductible (and treated as miscellaneous itemized deductions if incurred in an investment activity as described in item E.2, below). *Effective date.*—Taxable years beginning after 1985.
2. Charitable deduction for non-itemizers	Nonitemizers may deduct their charitable contributions in addition to taking the standard deduction (ZBA), subject to limitations for pre-1986 years. The maximum nonitemizer deduction was $25 for 1982 and 1983, and $75 for 1984. For 1985, 50 percent of contributions are deductible, without a dollar cap. For 1986, the full amount of contributions will be deductible. Under present law, no deduction (beyond the standard deduction) is provided for charitable contributions by nonitemizers made after 1986.	The President's proposal would repeal the nonitemizer charitable deduction for contributions made after 1985, i.e., one year earlier than the scheduled termination of the nonitemizer deduction under present law.	Same as President's proposal.
3. Adoption expenses	An itemized deduction is allowed for up to $1,500 of adoption fees and expenses (such as court costs and attorneys' fees) for the adoption of a child with special needs (sec. 222), i.e., handicapped or other children eligible for adoption assistance payments under the Social Secuity Act.	Repeals the adoption expense deduction in anticipation that a direct expenditure program would be enacted to continue Federal support for families adopting children with special needs. *Effective date.*—Generally January 1, 1987, except that present law would apply for pre-1986 adoptions and special phaseout rules would apply for adoptions during 1986.	Same as President's proposal: (a) the adoption expense deduction would be repealed; and (b) the Adoption Assistance program in Title IV-E of the Social Security Act would be amended to provide matching funds as an administrative expense for adoption expenses for any child with special needs who has been placed for adoption in accordance with applicable State and local law. Such expenses would include all qualified adoption expenses included in the current tax deduction provision. The effective date would be coordinated with repeal of the current tax deduction.

Item	Present Law	President's Proposal	Possible Option
. Expenses for Business or Investment			
1. Travel and entertainment expenses *a. Meal expenses*	Meal expenses that constitute ordinary and necessary business expenses generally are deductible if the meal takes place in an atmosphere conducive to business discussion (whether or not business is discussed).	Allowable deductions for a business meal would be limited to $25 times the number of participants in the meal, plus one-half of the excess. This limit would apply to a taxpayer's meals while away from home on business, but not to meals furnished on the premises of the taxpayer primarily for its employees.	75 percent of business meal expenses would be deductible. This rule also would apply to meals furnished on employer's premises to its employees, unless (i) taxed as compensation, (ii) excludable under the subsidized eating facility exclusion or as a de minimis fringe benefit (sec. 132).
b. Entertainment expenses other than for meals	In general, entertainment expenses are deductible if, in addition to constituting ordinary and necessary business expenses, they are either (1) directly related to the active conduct of the taxpayer's business, or (2) if directly preceding or following a substantial and bona fide business discussion, associated with the active conduct of the taxpayer's business.	Deductions for entertainment expenses would be denied, with the following limited exceptions: (i) expenses paid under a reimbursement arrangement (in which case the deduction would be denied to the party making the reimbursement), (ii) items taxed as compensation to the beneficiaries, (iii) recreational expenses for employees (e.g., Christmas parties), and (iv) items made available to the general public (e.g., samples and promotional activities).	50 percent of entertainment expenses would be deductible. Items treated as exceptions under the President's proposal would be deductible in full (with deduction limitation rule applicable to a party that reimburses entertainment expenses).
c. Travel expenses (other than conventions)	(1) Travel expenses incurred by the taxpayer while away from home in the conduct of a business generally are deductible. However, the cost of commuting to and from work is not deductible.	(1) No deduction would be allowed for the cost of luxury water transportation, to the extent in excess of the cost of otherwise available business transportation.	(1) The deduction for the cost of luxury water transportation would be limited to twice the highest Federal travel per diem times the number of days in transit.
	(2) Travel may qualify as a form of education, and thus may give rise to a deduction, on the ground that traveling itself maintains or improves existing employment skills or is required by an employer or by applicable laws or regulations.	(2) No deduction would be allowed for travel that would be deductible only on the ground that the travel constitutes a form of education.	(2) Same as President's proposal.
	(3) Travel away from home may give rise to a charitable deduction when— (i) an individual deducts out-of-pocket travel expenses on the ground that they were incurred in performing services for the charity; or (ii) the charity itself pays for travel by an individual who has made a contribution to the charity.	(3) None.	(3) Extend the present-law rule applicable to medical deductions for lodging costs away from home (sec. 213(d)(2)(B)) to charitable deductions claimed for transportation and other travel expenses incurred in performing services away from home for a charitable organization; i.e., no deduction would be allowed for such expenses (whether paid directly by the individual or indirectly through a contribution to the organization) unless "there is no significant element of personal pleasure, recreation, or vacation in the travel away from home."

Item	Present Law	President's Proposal	Possible Option
c. Travel expenses (other than conventions) (Cont.)	(4) There is no statutory time limit on the period during which a taxpayer may qualify as "away from home," thus giving rise to deductions for transportation expenses and meals, lodging, and other living expenses. For example, an individual who maintains a primary residence or principal place of business in one city may, under some circumstances, deduct the costs of living in another city, even for a period in excess of one year, in connection with temporary employment in that city.	(4) For purposes of determining whether an individual is away from home, work assignments that extend for more than one year in a location would be considered indefinite rather than temporary, and no deductions would be allowed for travel to and from the job site and the individual's residence or for meals and living expenses at the job site.	(4) Same as President's proposal.
d. Travel expenses for attending conventions	(1) The cost of attending a convention or seminar, either for business or for investment purposes, is deductible. However, no deduction is allowed for the cost of attending a convention outside of the North American area (i.e., not in the U.S., Canada, Mexico, or certain Caribbean countries) unless the taxpayer can show that it was as reasonable to hold the convention there as in the North American area.	(1) No special rule (see meal and entertainment limitations described above).	(1) The cost of attending a convention or seminar for investment purposes would not be deductible. For all conventions or seminars relating to a trade or business of the taxpayer, the deduction for travel expenses, other than for transportation, would be limited to 200 percent of the applicable Federal travel per diem. In addition, the foreign convention rule under present law would be retained.
	(2) Deductions for attending conventions held on cruise ships are limited to $2,000 per taxpayer per year, and are wholly disallowed unless the cruise ship is registered in the U.S. and stops at ports of call only in the U.S.	(2) No deduction would be allowed for the cost of attending conventions, seminars, or other meetings held aboard cruise ships. *Effective date* (all travel and entertainment).—Taxable years beginning after December 31, 1985.	(2) Retain present law, subject to the above new rules for conventions and seminars. *Effective date* (all travel and entertainment).—Same as President's proposal.
2. Employee business expenses, investment expenses, and other miscellaneous itemized deductions			
a. Miscellaneous itemized deductions	A number of expenses of producing income are allowable only as itemized deductions. This category, commonly called the "miscellaneous deductions," consists principally of certain employee business expenses, certain expenses of earning investment income, and expenses relating to filing tax returns.	The miscellaneous itemized deductions would be moved "above-the-line" (i.e., would also be deductible by nonitemizers), and allowed only to the extent that, when aggregated with the employee expenses described below, they exceeded one percent of the taxpayer's adjusted gross income (AGI).	Adopt the one-percent floor, but keep miscellaneous deductions below-the-line as an itemized deduction.

Item	Present Law	President's Proposal	Possible Option
2. Employee business expenses, investment expenses, and other miscellaneous deductions. (Cont.)			
b. "Above-the-line" expenses	Four types of employee business expenses are allowed "above-the-line" in calculating adjusted gross income, and thus are *not* among the miscellaneous itemized deductions: (1) expenses reimbursed by the employer, (2) employee travel expenses, (3) employee transportation expenses, and (4) business expenses of employees who are outside salespersons.	Employee expenses (other than those reimbursed by the employer) would be aggregated with the present miscellaneous deductions for purposes of the one-percent floor. In addition, State and local taxes (other than income taxes) that related to an investment activity of the taxpayer (other than one involving the production of rental or royalty income) would be aggregated with the miscellaneous deductions for purposes of the floor.	Same as President's proposal, except that the expanded group of miscellaneous deductions (i.e., including all employee business expenses other than those reimbursed by the employer, as well as certain State and local taxes incurred in an investment activity) would be allowable, to the extent in excess of the one-percent floor, only to itemizers.
c. Home office expense	An itemized deduction is allowed for use of a part of one's home as an office subject to the following restrictions: (1) use of the home office must be for the convenience of the employer, (2) the home office must be used regularly and exclusively either as the taxpayer's principal place of business, or to meet patients, clients, or customers, and (3) the deduction cannot exceed the taxpayer's gross income from the business. A recent case held that these limits do not apply when the taxpayer leases a portion of his home to his employer.	None.	The present-law limits would apply when the taxpayer leases a portion of his home to his employer. In addition, the home office deduction would be limited to the taxpayer's net income from the business (i.e., gross income minus deductions attributable to the business).
d. Hobby losses	Hobby losses are restricted to the amount of hobby income. An activity is presumed not to be a hobby if it is profitable in 2 out of 5 consecutive years, or 2 out of 7 years for horse breeding or racing. (However, an activity need not meet this standard in order to avoid treatment as a hobby.)	None.	Change hobby rule so that an activity (including horse breeding or racing) is presumed not to be a hobby if it is profitable in 3 out of 5 consecutive years.
e. Effective date		*Effective date.* (all employee business expenses, etc.).—Taxable years beginning after 1985.	*Effective date.* (all employee business expenses, etc.).—Same as President's proposal.

Item	Present Law	President's Proposal	Possible Option
F. Political Contributions Tax Credit	Individual taxpayers may claim a nonrefundable income tax credit equal to one-half the amount of their contributions to political candidates and certain political campaign organizations during the taxable year. The maximum allowable credit is $50 for an individual and $100 for a married couple filing a joint return.	The political contributions credit would be repealed. *Effective date.*—Taxable years beginning on or after January 1, 1986.	Same as President's proposal.
G. Presidential Campaign Checkoff	Individual taxpayers may allocate $1 ($2 on a joint return) of their Federal income tax liability to the Presidential Election Campaign Fund. Monies in this fund are used to finance the campaigns of presidential and vice-presidential candidates and the nominating conventions of some political parties.	The checkoff for the Presidential Election Campaign Fund would be repealed. *Effective date.*—Returns filed for 1986 (which, in general, must be filed on or before April 15, 1987).	Retain present law.

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Item	Present Law	President's Proposal	Possible Option
Depreciation			
1. Incentive depreciation system	Under the Accelerated Cost Recovery System ("ACRS"), recovery deductions are determined by applying a statutory percentage to an asset's original cost (adjusted for allowable investment tax credit). The classification of assets under ACRS generally is based on the Asset Depreciation Range ("ADR") system of prior law. Under the ADR system, a present class life ("midpoint") was provided for all assets used in the same activity, other than certain assets with common characteristics (e.g., cars):	ACRS would be replaced by the Capital Cost Recovery System ("CCRS"). Under CCRS, a recovery percentage would be applied to an asset's inflation-adjusted basis. Asset classifications under CCRS would not be based on ACRS or ADR; rather assets would be identified by descriptions drawn from the U.S. National Income and Products Account prepared by the Commerce Department:	Assets would be grouped according to the recovery periods used for purposes of the public property leasing rules, which is generally the ADR midpoint. Depreciable basis would not be indexed for inflation.
	3-year class: Property with an ADR midpoint of 4 years or less (such as cars and light-duty trucks), *plus* property used in connection with research & experimentation and certain horses. Method is 150 declining balance, switching to straight line, over 3 years.	*CCRS Class 1:* 3-year ACRS property. Method is equivalent to 220 percent declining balance method, switching to straight line, over 4 years.	*Class 1:* Property with an ADR midpoint under 5 years. Includes cars, light trucks, and motor vehicle manufacturing special tools. Method is 150 percent declining balance, switching to straight line, over 3 years.
	5-year class: All tangible personal property not included in any other class. Includes railroad track, commercial passenger aircraft, and single-purpose agricultural structures. Method is 150 percent declining balance, switching to straight line, over 5 years.	*CCRS Class 2:* Trucks, buses, trailers, and office, computing, and accounting equipment. Method is equivalent to 220 percent declining balance method, switching to straight line, over 5 years.	*Class 2:* Property with ADR midpoints from 5 to 6.5 *plus* computer-based telecommunications central office switching equipment. Includes trailers, computers, heavy trucks, and oil and gas drilling assets. Method is 150-percent declining balance, switching to straight line, over 5 years.
	10-year class: Public utility property with an ADR midpoint of 18.5 to 25 years, certain burners and boilers with an ADR midpoint of 25 years, and mobile homes. Method is 150 percent declining balance, switching to straight line, over 10 years.	*CCRS Class 3:* Construction machinery, tractors, aircraft, mining & oil field machinery, and instruments. Method is equivalent to 198 percent declining balance method, switching to straight line, over 6 years.	*Class 3:* Property with ADR midpoints from 7 to 10.5 Includes offshore drilling assets, buses, agricultural assets, breeding or work horses, and office furniture and fixtures. Method is 150 percent declining balance, switching to straight line, over 7 years.
	15-year public utility class: Other public utility property with an ADR midpoint of more than 25 years. Method is 150 percent declining balance, switching to straight line, over 15 years.	*CCRS Class 4:* All tangible personal property not included in any other class. Includes railroad track and furniture and fixtures. Method is 154 percent declining balance method, switching to straight line, over 7 years.	*Class 4:* Property with ADR midpoints from 11 to 17.5 and property not included in any other class. Includes race horses, mobile homes and offices, railroad track, and commercial passenger aircraft. Method is 150 percent declining balance, switching to straight line, over 11 years.
	15-year real property class: Low-income housing. Method is 200 percent declining balance, switching to straight line, over 15 years.	*CCRS Class 5:* Railroad structures, ships & boats, engines & turbines, plant & equipment for generation, transmission, and distribution of electricity and other power, and distribution plant for communication services. Method is equivalent to 170 percent declining balance method, switching to straight line, over ten years.	*Class 5:* Property with ADR midpoints from 18 to 34.5 *plus* low-income housing. Includes railroad structures, public utility property, and vessels. Method is 150 percent declining balance, switching to straight line, over 18 years.

Item	Present Law	President's Proposal	Possible Option
1. Incentive depreciation system—(Continued)	*18-year real property class:* Buildings and structures. With relatively few exceptions, ADR lives were not assigned to buildings. Method is 175 percent declining balance, switching to straight line, over 18 years.	*CCRS Class 6:* ACRS 18-year real property and low-income housing. Method is equivalent to 112 percent declining balance, switching to straight line, over 28 years.	*Class 6:* Property with ADR midpoints of 35 years or more and all other 18-year real property. Includes telephone distribution plant and gas utility distribution facility. Method is straight line, over 30 years.
a. Leased property	For purposes of the public property leasing provisions, the recovery period of leased property is equal to the longer of the ADR midpoint (40 years for structures) or 125 percent of the lease term.	No provision.	Under the incentive depreciation system, leased property in Classes 1–5, is classified by the longer of the ADR midpoint or 125 of lease term. Recovery period of leased property in Class 6 is the longer of the ADR midpoint (30 years for structures) or 125 percent of the lease term.
b. Luxury cars	ACRS is subject to fixed limitations for automobiles.	Retain present law.	Same as President's proposal.
c. Changes in classification	Under ACRS, recovery periods are fixed.	Treasury would monitor and analyze actual experience with all tangible depreciable assets so that changes could be made.	Same as President's proposal, *plus* Treasury would be directed to establish tentative ADR midpoints for railroad track, and mobile homes and offices by January 1, 1986.
d. Definition of low-income housing	Low-income housing generally is defined in relation to HUD programs. One rule defines low-income housing as a project where 85% of tenants are eligible for, but do not necessarily receive, Section 8 subsidies. Presently Section 8 eligibility is defined as families whose income is 50% or less of area median income, adjusted for family size.	No provision.	Low-income housing would be defined solely by reference to Section 8 eligibility by 85% of tenants.
2. Alternative cost recovery system	ACRS deductions are reduced for property that is (1) used predominantly outside the United States, (2) leased to a tax-exempt entity, or (3) financed with industrial development bonds the interest on which is exempt from tax. Different depreciation methods are also used for purposes of (1) computing earnings and profits of a domestic corporation, and (2) applying the minimum tax provisions.	A system intended to allow depreciation deductions that approximate the assumed decline in an asset's value would apply. Although no specific system is recommended, the Administration proposal indicates that the depreciation system set forth in the 1984 Treasury report ("RCRS") would serve as the model. Under RCRS, the inflation-adjusted basis of property would be recovered over periods ranging from 5 years for short-lived property to 63 years for real property.	Depreciation deductions would be computed under the method that is used under present law for property that is leased to a tax-exempt entity, which is generally straight-line over the ADR midpoint life. This method could be elected by a taxpayer for property otherwise eligible for incentive depreciation, on a class-by-class, year-by-year basis.
a. Property predominatly of foreign origin	There is Presidential authority to deny the investment tax credit, but not accelerated depreciation.	No provision.	Provide Presidential authority to deny accelerated depreciation to property produced abroad, similar to present-law rules applicable to the investment tax credit.

Item	Present Law	President's Proposal	Possible Option
b. Property used in outer space	No provision.	No provision.	Property launched by a U.S. person from the United States and used in outer space would not be treated as foreign-use property.
3. Indexing	The basis of depreciable property is not adjusted for inflation; however, depreciation allowances are accelerated, in part, to compensate for inflation.	Beginning with the second year an asset is in service, the asset's unrecovered basis would be adjusted upwards for inflation.	Retain present law.
4. Conventions			
a. half-year	The statutory schedules for personal property reflect a half-year convention that results in a half-year depreciation allowance for the first recovery year, regardless of when property is placed in service during the year.	The depreciation allowance for the first year would be based on the number of months the asset was in service.	For personal property, both the first and last depreciation allowances for an asset would reflect the half-year convention.
b. mid-month	Under a mid-month convention, real property (other than low-income housing) placed in service or disposed of at any time during a month is treated as having been placed in service or disposed of in the middle of the month.	The same mid-month convention that applies to most real property under present law would apply to all property.	For real property, retain present law. For personal property, the mid-month convention would apply to taxpayers who place more than 40 percent of property in service during the last quarter of the taxable year.
5. Gain on disposition	With limited exceptions, gain is "recaptured" as ordinary income to the extent of previously allowed depreciation deductions. Gain in excess of amounts subject to recapture is treated as capital gain.	All gain on disposition of depreciable property would be taxed as ordinary income.	Recapture gain to the extent of previously allowed depreciation for all property. *Effective date.*—Assets placed in service after December 31, 1985, except if acquired pursuant to a written contract that was binding on September 25, 1985.
a. residential real property	For residential real property held for more than one year, gain is recaptured only to the extent that accelerated depreciation deductions exceed straight-line deductions. Recapture for low-income housing is phased out after property has been held for a prescribed period.	No provision.	
b. nonresidential real property	There is no recapture if the taxpayer elected to recover the property's cost using the straight-line method. Otherwise, the full amount of depreciation—to extent of gain—is recaptured.	No provision.	
6. Lessee leasehold improvements	A lessee recovers the cost of leasehold improvements over the shorter of the property's ACRS recovery period or the portion of the lease term remaining on the date the property is acquired.	The cost of leasehold improvements made by a lessee would be recovered under the general rules, without regard to the lease term, except where the improvement is reasonably expected to have no residual value on expiration of the lease.	A lessee would recover capital costs under the general rules in every case.

Item	Present Law	President's Proposal	Possible Option
7. Repair allowances	Expenditures that prolong the life of an asset are recoverable in the same manner as the cost of a capital asset. Other expenditures for repair or maintenance are expensed. The characterization of an expense as a capital expenditure or a deductible repair requires a factual determination.	Each asset class would be assigned a safe-harbor repair allowance factor. A taxpayer would automatically deduct expenses to the extent the expenses do not exceed the product of the asset's inflation-adjusted basis multiplied by the repair allowance factor.	Retain present law.
8. Expensing	Taxpayers can elect to expense up to $5,000 of the cost of personal property. The $5,000 ceiling is scheduled to increase to $7,500 for taxable years beginning in 1988 and 1989, and to $10,000 for years beginning after 1989.	The scheduled increases in the ceiling would be repealed.	Provide a $10,000 ceiling and limit eligibility for expensing to taxpayer whose total investment in tangible personal property for taxable year is $200,000 or less.
9. Vintage accounts	Taxpayers generally compute depreciation deductions on an asset-by-asset basis. There is an election to establish mass asset vintage accounts for assets in the same recovery class and placed in service in the same year. The definition of assets eligible for inclusion in mass asset accounts is limited, primarily because of concern about the mechanics of recapturing investment tax credits.	Mass asset vintage accounts would be retained for property qualifying for such treatment under ACRS.	With repeal of the investment tax credit, the definition of eligible property would be expanded to include all property.
10. Public utility property	The benefits of accelerated depreciation must be normalized.	Same as present law.	Same as present law.
11. Effective date	No provision.	CCRS would be effective for property placed in service on or after January 1, 1986.	Same as President's proposal.
a. Anti-churning rules	No provision.	Under rules similar to those enacted as part of ACRS, but not yet specified, taxpayers would be prevented from bringing property placed in service before the effective date under CCRS by certain post-effective date transactions.	No provision.

Item	Present Law	President's Proposal	Possible Option
b. Transition rules	No provision.	No provision.	ACRS would apply to: (i) property that is constructed, reconstructed, or acquired pursuant to a written contract that was binding as of September 25, 1985, or (ii) property constructed or reconstructed by the taxpayer, if the lesser of $1 million or 5 percent of cost has been incurred or committed by September 25, 1985, if construction commenced by that date, or (iii) an equipped building or a plant facility, if construction has commenced as of September 25, 1985, pursuant to a written specific plan, and more than half of the cost has been incurred or committed by that date, and (iv) property or project is placed in service by July 1, 1986, in the case of Class 1 property; by January 1, 1987, in the case of Class 2-4 property; and January 1, 1988, in the case of Class 5 and 6 property. (v) ACRS would apply to property that qualifies under (i) or (ii) and (iv), but is sold and leased back by the person initially committed to acquire the property within a 3-month window.
Windfall Recapture of Excess Accelerated Depreciation	Taxpayers who defer tax liability by taking accelerated depreciation deductions at present-law rates normally pay the deferred taxes only when and as the investment either produces taxable income or is disposed of at a gain.	Taxpayers who deferred tax liability by taking accelerated depreciation deductions at present-law rates would include 40 percent of "excess depreciation" (i.e., the excess of accelerated depreciation deductions over depreciation allowances for purposes of computing earnings and profits) in income over a three-year period. *Effective date.*—The proposed recapture rule would apply to excess depreciation taken between January 1, 1980, through June 30, 1986. Certain dispositions before July 1, 1986, would be disregarded.	No provision.

Item	Present Law	President's Proposal	Possible Option
Regular Investment Tax Credit			
1. Allowable credit	A credit against income tax liability is allowed for up to ten percent of a taxpayer's investment in tangible personal property (six percent for property in the three-year ACRS class).	The regular investment tax credit would be repealed.	Same as President's proposal.
2. Public utility property	For public utility property, the tax benefits of the credit must be normalized.	Normalization rules would be retained for the unamortized portion of investment tax credits allowed to public utilities.	Same as President's proposal.
3. Effective date			
a. General	No provision.	Repeal would be effective for property placed in service on or after January 1, 1986.	Same as President's proposal.
b. Transition rules	No provision.	No provision.	The credit would be available under the same circumstances in which present-law depreciation rules would continue to apply. A taxpayer would spread the credit earned on transition property ratably over 5 years. A basis adjustment would be required for the full investment credit in the first taxable year.
4. Finance leases	Under the finance lease rules, the fact that a lessee has a fixed-price option to purchase the property or the leased property is limited use property is not taken into account in determining whether the agreement is a lease. The finance lease rules are scheduled to go into effect after December 31, 1987, although the rules are available currently for limited categories of property.	No provision.	Repeal the finance lease rules. *Effective date.*—Agreements entered into on or after January 1, 1986 (for property that qualifies for finance lease transition rules under prior tax acts, January 1, 1988).

Item	Present Law	President's Proposal	Possible Option
Rapid Amortization Provisions			
1. Five-year amortization of trademark and trade name expenditures	Taxpayers may elect to amortize over a period of at least 60 months expenditures for the acquisition, protection, expansion, registration, or defense of a trademark or trade name, other than an expenditure which is part of the consideration for an existing trademark or trade name.	The election would be repealed. Trademark and trade name expenditures would therefore generally be capitalized and recovered on a disposition of the asset, in the absence of a showing of a shorter determinable useful life. *Effective date.*—The repeal would be effective for expenditures paid or incurred on or after January 1, 1986.	Same as President's proposal. *Transition rule.*—Present law would continue to apply to expenditures incurred: (i) pursuant to a written contract that was binding as of September 25, 1985; or (ii) with respect to development, protection, expansion, registration or defense commenced as of September 25, 1985, if the lesser of $1 million or 5 percent of cost has been incurred or committed by that date; provided in each case the trademark and trade name is placed in service before January 1, 1988.
2. Five-year amortization of pollution control facilities	Taxpayers may elect to amortize over a 60-month period the cost of a qualifying certified pollution control facility used in connection with a plant that was in operation before 1976. To the extent that a pollution control facility has a useful life in excess of 15 years, a portion of the facility's cost is not eligible for 60-month amortization, but must be recovered through depreciation.	The election would be repealed. Expenditures for pollution control facilities would therefore be recovered in accordance with the applicable depreciation schedules. *Effective date.*—The repeal would be effective for expenditures paid or incurred on or after January 1, 1986.	Same as President's proposal. *Transition rule.*—Present law would continue to apply to expenditures incurred: (i) pursuant to a written contract that was binding as of September 25, 1985; or (ii) with respect to facilities, construction of which is commenced as of September 25, 1985, if the lesser of $1 million or 5 percent of the cost has been incurred or committed by that date, provided in each case the facility is placed in service before January 1, 1988.

Item	Present Law	President's Proposal	Possible Option
Five-year amortization of expenditures to rehabilitate low-income housing	Taxpayers may elect to amortize over a 60 month period certain qualifying expenditures for additions or improvements to low-income rental housing with a useful life of at least five years (other than hotels or other similar facilities primarily serving transients). Expenditures in any year for any dwelling unit are eligible only if the aggregate amount of expenditures for such unit exceeds $3,000 over two consecutive taxable years. Expenditures for any dwelling unit are not generally eligible to the extent that they aggregate more than $20,000. (In certain cases, $40,000.) The election is scheduled to expire for expenditures incurred after December 31, 1986 (except in cases where rehabilitation began, or a binding contract for such expenditures was entered into, before January 1, 1987).	The election would be repealed. Expenditures for low-income housing would therefore be recovered in accordance with the applicable depreciation schedules. *Effective date.*—The repeal would be effective for expenditures paid or incurred on or after January 1, 1986.	Retain present law with a modification: replace $20,000 and $40,000 aggregate expenditure limits with a single $30,000 limit. *Effective date.*—The modification to the aggregate limit would apply to permit additional expenditures, over the present $20,000 limit, in the case of expenditures paid or incurred on or after January 1, 1986. *Transitional rule.*—The $40,000 limit would continue for expenses incurred: (i) pursuant to a written contract that was binding as of September 25, 1985; or (ii) with respect to rehabilitation commenced as of September 25, 1985, if 5 percent of the cost has been incurred or committed by that date, provided in each case the additions or improvements are placed in service before January 1, 1988.
Fifty-year amortization of qualified railroad grading and tunnel bores	Domestic railroad common carriers may elect to amortize the cost of qualified railroad grading and tunnel bores over a 50 year period. "Qualified railroad grading and tunnel bores" include all land improvements (including tunneling) necessary to provide, construct, reconstruct, alter, protect, improve, replace, or restore a roadbed or right-of-way for railroad track.	The election would be repealed. Expenditures for railroad grading and tunnel bores would therefore be capitalized and recovered on disposition of the asset, in the absence of a showing of a shorter useful life. *Effective date.*—The repeal would be effective for expenses paid or incurred on or after January 1, 1986.	Same as President's proposal. *Transition rule.*—Present law would continue to apply to expenditures incurred: (i) pursuant to a written contract that was binding as of September 25, 1985; or (ii) with respect to construction, reconstruction, alteration, improvement, replacement or restoration commenced as of September 25, 1985, if the lesser of $1 million or 5 percent of cost has been incurred or committed by that date, provided in each case the improvements are placed in service before January 1, 1988.

Item	Present Law	President's Proposal	Possible Option
Special expensing, rapid amortization, and investment credit provisions affecting agriculture and forestry			
a. Soil and water conservation expenditures	Certain expenditures incurred by farmers for soil and water conservation improvements may be expensed rather than capitalized. The deduction in each year may not exceed 25 percent of gross income derived from farming.	Repealed. *Effective date.*—Expenditures after December 31, 1985.	Same as President's proposal.
b. Fertilizer and soil conditioning expenditures	Certain expenditures incurred for fertilizer and soil conditioning may be expensed rather than capitalized.	Repealed. *Effective date.*—Expenditures after December 31, 1985.	Same as President's proposal.
c. Land clearing expenditures	Certain expenditures incurred by farmers for land clearing may be expensed rather than capitalized. The deduction in any year may not exceed the lesser of $5,000 or 25 percent of taxable income from farming.	Repealed. *Effective date.*—Expenditures after December 31, 1985.	Same as President's proposal.
d. Amortization of and investment credit for reforestation expenditures	Taxpayers may amortize over a 7-year period up to $10,000 of reforestation expenditures incurred in each taxable year. A 10-percent tax credit is allowable for these expenditures.	Repealed. *Effective date.*—Expenditures after December 31, 1985.	Same as President's proposal.

Item	Present Law	President's Proposal	Possible Option
. Other Capital-Related Costs			
1. Expensing of R&E expenditures and incremental research tax credit.			
a. Expensing	A taxpayer may elect to deduct currently the amount of research and experimental expenditures incurred in connection with a business (sec. 174), notwithstanding the general rule that expenditures having a useful life beyond the current year must be capitalized. This expensing applies to "research and development costs in the experimental or laboratory sense." The amount of the section 174 deduction is not reduced by the amount of the research credit.	No proposal.	An anti-"double dip" rule would be adopted under which no deduction would be allowed for that portion of research expenditures which equals the amount of the research credit allowable for the year. *Effective date.*—Taxable years beginning after 1985.
b. Incremental tax credit	*Expiration date.*—Under present law, the credit will not apply to expenses paid or incurred after December 31, 1985.	*Expiration date.*—The research credit would be extended for an additional three years, through December 31, 1988.	*Expiration date.*—Same as President's proposal (three-year extension).
	Structure.—The taxpayer may claim a 25-percent tax credit for excess of (1) qualified research expenditures for the taxable year incurred in carrying on a business over (2) the average amount of the taxpayer's yearly qualified research expenditures in the preceding three taxable years (sec. 30).	*Structure.*—Same as present law (25-percent incremental credit).	*Structure.*—Same as present law (incremental credit), but reduce credit rate to 20 percent and adjust base period amounts to reflect inflation.
	Research definition.—The credit provision adopts the deduction definition of research, (in sec. 174), but subject to three exclusions: (1) research conducted outside the U.S.; (2) research in the social sciences or humanities; and (3) research to the extent funded, through grant or contract, by another person or governmental entity.	*Research definition.*—The definition of qualified research (for purposes of the credit) would be revised to limit the credit to research activities involving a process of experimentation intended to result in technological innovations in products and production processes, effective for expenditures paid after 1985.	*Research definition.*—The definition of research (for purposes of the credit and expensing deduction) would be clarified through committee report language defining "research or experimental," and nonresearch activities or applicable exclusions, such as mere style, packaging, or seasonal design changes in products; duplication and adaptation; post-research and production-related activities; quality-control testing and routine data collection; management and marketing studies; and routine development of internal-use computer software.
	Qualified expenditures.—Research expenditures eligible for the credit consist of (1) in-house expenditures for research wages and supplies; (2) rental or user fees for research use of laboratory equipment, computers, or other personal property; (3) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf; and (4) 65 percent of a corporate taxpayer's expenditures (including grants or contributions) for basic research performed by universities or certain scientific research organizations.	*Qualified expenditures.*—No proposal.	*Qualified expenditures.*—Treat leased research equipment the same as purchased equipment; i.e., rental and similar payments for personal property (other than payments to others for use of computer time) would be ineligible for the credit.

Item	Present Law	President's Proposal	Possible Option
b. incremental tax credit (Cont.)	*Credit use limitation.*—The research credit is not subject to the general limitation on use of business credits (85% of tax liability over $25,000).	*Credit use limitation.*—No proposal.	*Credit use limitation.*—The general limitation on business credits would apply to the research credit. *Effective date.*—Expenditures/taxable years after 1985.
2. Tax credit for rehabilitation expenditures			
a. 15- and 20-percent credits	The credit is 15 percent for nonresidential buildings at least 30 years old, and 20 percent for nonresidential buildings at least 40 years old. If the 15- or 20-percent credit is allowed, depreciable basis is reduced by the amount of credit earned. The credit is available only if the taxpayer elects to use the straight-line method of cost recovery with respect to rehabilitation expenditures.	The 15- and 20-percent credits would be repealed. *Effective date.*—January 1, 1986.	Provide one 10-percent credit. Limit credit to buildings constructed before 1935. *Effective date.*—Property placed in service on or after January 1, 1986.
b. Certified historic structures	The credit is 25 percent for certified historic structures. If the 25-percent credit is allowed, depreciable basis is reduced by 50 percent of the amount of credit earned. The credit is available only if the taxpayer elects to use the straight-line method of cost recovery with respect to rehabilitation expenditures.	The credit for rehabilitations of certified historic structures would be repealed. *Effective date.*—January 1, 1986.	Reduce credit to 20 percent, and require a full-basis adjustment. *Effective date.*—Property placed in service on or after January 1, 1986.
c. Transition rules	No provision.	Credits would be allowed with respect to pre-effective date expenditures if pre-effective date expenditures plus post-effective date expenditures qualify under test of a substantial rehabilitation.	Credits would be available if: (i) rehabilitation completed pursuant to a written contract that was binding on September 25, 1985, and placed in service before January 1, 1988, or (ii) the building is acquired and either Part 2 of the Historic Preservation Certification Application has been submitted to the Interior Department or its designate, or the lesser of $1 million or 5 percent of rehabilitation's cost was incurred or required to be incurred pursuant to a binding contract entered into as of September 25, 1985, and placed in service before January 1, 1988. If a rehabilitation qualifies under (i) or (ii), present law depreciation rules continue to apply (except full basis adjustment required for historic structures), and the credits are reduced: from 15 percent to 10 percent, from 20 percent to 13 percent, or from 25 percent to 20 percent.

Item	Present Law	President's Proposal	Possible Option
3. Merchant marine capital construction fund	Taxpayers are entitled to deduct certain amounts deposited in a capital construction fund. Earnings from the investment or reinvestment of amounts in a capital construction fund are excluded from income.	The rule providing special tax treatment for capital construction funds would be repealed. *Effective date.*—No tax-free contributions to capital construction funds could be made after December 31, 1985, except with respect to vessels the taxpayer owned on January 1, 1986, or vessels with respect to which the taxpayer performs a substantial amount of construction or reconstruction before January 1, 1986. Amounts remaining in a capital construction fund on January 1, 1996, would be treated as withdrawn at that time.	Same as President's proposal.
4. Tax credit for orphan drug clinical testing	A 50-percent tax credit is allowed for a taxpayer's expenses of clinical testing of certain drugs for rare (in U.S.) diseases or conditions. The credit expires after 1987.	Same as present law.	Same as present law.
5. Limitation on business tax credits	The business tax credits earned by a taxpayer can be used to reduce up to 85 percent of tax liability in excess of $25,000.	No provision.	The limitation on the amount of income tax liability (in excess of $25,000) would be reduced from 85 percent to 75 percent. *Effective date.*—Taxable years beginning after December 31, 1985.

Item	Present Law	President's Proposal	Possible Option
'. Capital Gains and Losses			
1. Individual long-term capital gain tax rate (See III. A. for Corporate Capital Gain Tax Rate.)	An individual may deduct from gross income 60 percent of net capital gain (the excess of net long-term capital gain over any net short-term capital loss). Since the maximum regular individual tax rate is 50 percent, the deduction means that net capital gain is taxed at a maximum rate of 20 percent. The alternative minimum tax, which applies only if greater than the regular tax, is also 20 percent. Thus, although the deducted portion of capital gains is a preference item, the alternative minimum tax does not increase the maximum rate on net capital gain.	50 percent of an individual's net capital gain would be deductible. Since the highest regular tax rate for individuals would be 35 percent, the highest rate applicable to such net capital gain would be 17.5 percent. However, taxpayers subject to the alternative minimum tax would be potentially subject to a 20 percent rate on net capital gain. For sales after 1990, individuals could elect annually to compute gain by indexing the basis of capital assets, instead of deducting a portion of unindexed gain from gross income. *Effective date.*—July 1, 1986. A taxpayer with a fiscal year that includes but does not begin on July 1, 1986 would use a blended percentage deduction for sales at any time during the year 1986.	40 percent of an individual's net capital gain would be deductible. Since the highest regular rate for individuals would be 35 percent, the highest rate applicable to such net capital gain would be 21 percent. No indexing the basis of capital assets after 1990. *Effective date.*—Sales on or after January 1, 1986.
2. Assets eligible for long-term capital gain treatment	Capital assets held more than 6 months are eligible for long-term capital gain treatment upon sale. In addition, net gain from the sale of certain assets that are not capital assets is eligible for long-term capital gain treatment. These assets, known as "Section 1231" assets, include depreciable property and land used in the taxpayer's trade or business (but not held for sale to customers). Also included are certain "special assets" important in particular industries, such as interests in timber, coal, domestic iron ore, certain livestock and certain unharvested crops. If there is a net loss from sale of section 1231 assets, the loss is deductible as an ordinary loss. On a disposition of assets, certain items that previously were deducted are recaptured as ordinary income, up to the amount of gain. All depreciation previously taken is recaptured on a sale of personal property. However, on a sale of depreciated real property held for more than a year, there is generally no recapture if depreciation was taken on a straight-line basis. In the case of residential real property, even if accelerated depreciation was taken, only the excess over straight-line depreciation is recaptured. Expensed intangible drilling costs incurred after 1975 are recaptured to the extent of the excess of such costs over the amount that would have been deducted if the costs had been capitalized	(a) The basis of section 1231 assets that are no longer eligible for capital gain treatment (see (b) below) would be indexed for inflation. (b) Net gain from the sale of section 1231 assets would no longer be eligible for long-term capital gain treatment, except in the case of land used in a trade or business (or in an unusual case where a "special asset" might otherwise qualify as a capital asset). *Effective date.*—Generally applies to all depreciable property placed in service by the taxpayer after 1985. However, the new rules for "special assets" would be phased in over 3 years.	(a) Retain present law. (b) Retain capital gain treatment, except for recapture, on disposition (up to present law gain limit), of all depreciation taken on real (as well as personal) property and of other deductions that have previously reduced adjusted basis or amounts that, but for a special expensing provision, would have been capitalized and added to basis of real or personal property (other than research and experimental expenditures). (For treatment of coal, domestic iron ore and timber, see II. I. 1. and 2, below.) *Effective date.*—Recapture changes apply to dispositions of property placed in service by the taxpayer after December 31, 1985, except if acquired pursuant to a written contract that was binding on September 25, 1985.

Item	Present Law	President's Proposal	Possible Option
2. Assets eligible for long-term capital gain treatment—Continued	and deducted through depletion. Certain other expensed or rapidly amortized items are recaptured under rules similar to those for depreciation. The Code does not provide for the recapture of certain other amounts. Recapture rules also serve to limit nonrecognition rules applying to certain transactions (e.g., corporate liquidations and installment sales).		

Item	Present Law	President's Proposal	Possible Option
Oil and Gas			
1. Intangible drilling costs			
a. General rule	Intangible drilling and development costs (IDCs) generally may be expensed or capitalized at the election of the operator of an oil, gas, or geothermal property. In the case of integrated producers, 80% of IDCs may be deducted currently and the remaining 20% must be amortized over a 36-month period beginning with the month the costs are paid or incurred. Costs with respect to a nonproductive well ("dry hole") may be deducted currently by any taxpayer in the year the dry hole is completed.	Retain present law.	Same as President's proposal, but require recapture of expensed IDCs on productive wells at the time the well is placed in service. Recaptured amounts, and IDCs incurred after the well is placed in service, would then be recovered in the same manner as depreciable property in Class 1 (3-year recovery period). *Effective date.*—Costs paid or incurred after 1985.
b. Treatment of foreign IDCs	IDCs qualify for expensing whether incurred in the United States or in a foreign country.	Retain present law.	IDCs incurred outside of the United States would be recovered, at the election of the operator, (i) over a 10-year, straight-line amortization schedule, or (ii) as part of the basis for cost depletion. *Effective date.*—Costs paid or incurred after 1985.
2. Depletion for oil and gas	Depletable costs with respect to oil and gas properties must be recovered using whichever of two methods provides the higher deduction: cost depletion or percentage depletion. Under cost depletion, the fraction of depletable costs recovered is equal to the ratio of hydrocarbons produced during the taxable year to total remaining reserves. Under percentage depletion, 15% of the taxpayer's gross income is allowed as a dedcution in any taxable year, not to exceed (i) 50% of net income from the property, or (ii) 65% of overall taxable income. Percentage depletion for oil and gas properties is limited to independent producers and royalty owners for up to 1,000 barrels of daily production.	Phase out percentage depletion for most oil and gas properties over a 5-year period, by reducing depletion rate 3 percentage points in each year. Percentage depletion would be retained for stripper wells owned by independent producers, but would not be available to royalty owners. The basis for cost depletion would be indexed for inflation. *Effective date.*—Production on or after January 1, 1986.	Same as President's proposal, except— (1) Percentage depletion would not be retained for stripper wells, (2) No indexing of cost depletion basis, and (3) Phase out period is 3 years instead of 5 years (5 percentage point reduction in each year).
3. Tertiary injectants	Expenditures for tertiary injectants used to enhance oil and gas production may be deducted in the year of injection.	Retain present law.	Defer one-half of deduction for tertiary injectant expenditures until year after deduction is allowed under present law. *Effective date.*—Tertiary injectants injected after 1985.

Item	Present Law	President's Proposal	Possible Option
I. Hard Minerals 1. Exploration and development costs *a. General rule*	Exploration and development costs associated with mines and other hard mineral deposits may be deducted currently at the election of the taxpayer. Exploration (but not development) costs which have been deducted currently either (1) are applied to reduce depletion deductions, or (2) at the taxpayer's election, are recaptured in income once the mine begins production, and then recovered as a depletable expense. In the case of corporations, only 80% of hard mineral exploration and development costs may be expensed. The remaining 20% must be recovered over the 5-year ACRS depreciation schedule (beginning in the year that exploration and development costs are paid or incurred), with an investment tax credit for domestic costs.	Retain present law.	Same as President's proposal, but require recapture of both expensed development and exploration costs at the time the mine begins production. Recaptured amounts, and development costs incurred after the mine begins production, would be recovered in the same manner as depreciable property in Class 1 (3-year recovery period). The 20 percent of corporate exploration and development costs that are not expensed would be recovered in the same manner as depreciable property in Class 2 (5-year recovery period), beginning in the year that costs are paid or incurred. *Effective date.*—Costs paid or incurred after 1985.
b. Foreign exploration costs	Foreign exploration costs must be capitalized to the extent the taxpayer's foreign and domestic exploration costs exceed $400,000 per year.	Retain present law.	Foreign exploration and development costs would be recovered, at the taxpayer's election, (i) over a 10-year, straight-line amortization schedule, or (ii) as part of the basis for cost depletion. *Effective date.*—Costs paid or incurred after 1985.
2. Depletion of hard mineral deposits	Depletable costs with respect to hard mineral deposits must be recovered using the greater of— (1) cost depletion, or (2) percentage depletion at the applicable statutory rate for the mineral. Percentage depletion may not exceed 50% of net income from the property in any taxable year. For corporations only, percentage depletion of coal or iron ore, in excess of adjusted basis (determined without regard to the depletion deduction for that year), is reduced by 15 percent.	Phase out percentage depletion of hard minerals ratably over a 5-year period. The basis for cost depletion of hard minerals would be indexed for inflation. *Effective date.*—Production on or after January 1, 1986.	Same as President's proposal except— (1) Phase out period is 3 years instead of 5 years, and (2) No indexing of cost depletion basis.

Item	Present Law	President's Proposal	Possible Option
Capital Gains for Coal, Iron Ore, and Timber			
1. Capital gain treatment for coal and domestic iron ore royalties	Royalties on dispositions of coal and domestic iron ore qualify for capital gain treatment, provided the coal or iron ore is held for more than six months before mining. Capital gain treatment does not apply to (i) income realized as a co-adventurer, partner, or principal in the mining of coal or iron ore, or (ii) certain related party transactions. If capital gain treatment applies, the royalty owner is not entitled to percentage depletion with respect to the same coal or iron ore.	Phase out special capital gain treatment over a 3-year period beginning January 1, 1986. *Effective date.*—Royalties received on or after January 1, 1986. For individuals, the exclusion rate on capital gains from coal and domestic iron ore royalties would be reduced to 30% in 1986, 20% in 1987, 10% in 1988, and 0 percent thereafter. For corporations, the tax rate on such capital gains would increase to 30% in 1986, 31% in 1987, 32% in 1988, and would be taxed at ordinary corporate rates thereafter.	Same as President's proposal.
2. Capital gain rules applicable to timber			
a. Timber royalties	Timber royalty income qualifies for capital gain treatment, where the timber is held for 6 months before being cut.	Phase out special capital gain treatment over a 3-year period beginning January 1, 1986. *Effective date.*—Royalties received on or after January 1, 1986. For individuals, the exclusion rate on capital gains from timber royalties would be reduced to 30% in 1986, 20% in 1987, 10% in 1988, and 0 percent thereafter. For corporations, the tax rate on such capital gains would increase to 30% in 1986, 31% in 1987, 32% in 1988, and would be taxed at ordinary corporate rates thereafter.	Same as President's proposal.
b. Cutting as sale or exchange	Owners of timber (or a contract right to cut timber) may elect to treat the cutting of timber as a sale or exchange qualifying for capital gain treatment, even though the timber is sold or used in the taxpayer's trade or business. To qualify, the timber (or contract cutting right) must be held for 6 months prior to cutting.	Phase out special capital gain treatment over a 3-year period beginning January 1, 1986. *Effective date.*—Timber cut on or after January 1, 1986. For individuals, the exclusion rate on capital gains from the cutting of timber would be reduced to 30% in 1986, 20% in 1987, 10% in 1988, and 0 percent thereafter. For corporations, the tax rate on such capital gains would increase to 30% in 1986, 31% in 1987, 32% in 1988, and would be taxed at ordinary corporate rates thereafter.	Same as President's proposal.

Item	Present Law	President's Proposal	Possible Option
Energy-Related Tax Credits and Other Incentives			
1. Residential energy tax credits			
a. Energy conservation items and insulation credit	A 15-percent tax credit is allowed on the first $2,000 spent through 1985 for installations in a taxpayer's principal residence ($300 maximum credit) of items to reduce heat loss or gain, increase heating system efficiency, or reduce fuel consumption. Unused credits may be carried over through 1987.	Allows the credit to expire as under present law.	Same as President's proposal.
b. Renewable energy credit	A 40-percent tax credit is allowed on the first $10,000 spent through 1985 for renewable energy property, i.e., solar, wind and geothermal ($4,000 maximum credit). Unused credits may be carried over through 1987. Eligible equipment and parts include those necessary to transmit or use geothermal energy.	Allows the credit to expire as under present law.	Same as President's proposal.
2. Business energy tax credits			
a. Credit allowed	The business energy tax credits are available in addition to the investment tax credit. *Solar, wind, geothermal and ocean thermal property:* 15-percent credit through 1985. *Intercity buses and biomass property:* 10-percent credit through 1985. *Small-scale hydroelectric projects:* 11-percent credit through 1985, or 1988 if application docketed by FERC before 1986.	Allow credits to expire as under present law.	Same as President's proposal.
b. Unused credits	Unused energy tax credits may be carried back 3 years and carried forward 15 years.	Retain present law carryover of unused credits.	Same as President's proposal.

Item	Present Law	President's Proposal	Possible Option
2. Business energy tax credits (Cont.) *c. Affirmative commitment rules*	The expired 10-percent credit for alternative, etc., energy property continues to be available for long-term projects which meet rules requiring completion of engineering studies and application for all required permits before 1983, entering into binding contracts for 50% of special project equipment before 1986, and project completion before 1991.	Retain present law affirmative commitment rules (including hydroelectric).	Spread credit allowable each year over 5 years, i.e., 20 percent of the credit allowed for any years may be taken in each of 5 years.
3. Credit for fuels from nonconventional sources	A tax credit is provided for the domestic production and sale of specified fuels from nonconventional sources. The credit applies to eligible fuels sold after December 31, 1979, and before January 1, 2001, produced from: (1) facilities placed in service after December 31, 1979, and before January 1, 1990, or (2) wells drilled after December 31, 1979, and before January 1, 1990, on properties which first began production after December 31, 1979.	The credit generally would terminate after December 31, 1985. Under a transitional provision, the credit would continue to be available for qualifying fuel which is produced from a well drilled, or facility completed, before January 1, 1986, and which is sold before January 1, 1990.	Same as President's proposal.
4. Alcohol fuels credit and tax exemptions *a. Alcohol fuels income tax credit*	A 60-cents-per-gallon credit is allowed for alcohol mixed with gasoline, diesel fuel, or any special motor fuel, if the mixture is sold or used as fuel. The credit also is provided for alcohol used in a trade or business or sold at retail and placed in a vehicle fuel tank. Eligible alcohol includes ethanol and methanol but not if made from petroleum, natural gas, or coal (including peat), or alcohol less than 150 proof. The credit is scheduled to expire after December 31, 1992.	After December 31, 1985, the alcohol fuels tax credit would be available only for alcohol fuels produced from facilities completed before January 1, 1986, and sold before January 1, 1993.	Same as President's proposal.

Item	Present Law	President's Proposal	Possible Option
. **Alcohol fuels credit and tax exemptions—Cont.**			
b. Excise tax exemptions	(1) *Alcohol fuels mixtures.*—A 6-cents-per-gallon exemption from excise taxes on gasoline, diesel fuel, and special motor fuels is provided for these fuels if they are mixed with at least 10 percent alcohol. Eligible alcohol may not be derived from petroleum, natural gas, or coal. The exemption is scheduled to expire after December 31, 1992.	(1) Repeal excise tax exemptions after 1985.	Same as President's proposal.
	(2) *Alcohol fuels.*—A 9-cents-per-gallon exemption from the excise tax on special motor fuels is provided for neat methanol and ethanol fuels which are not derived from petroleum or natural gas. A 4½ cents exemption is provided if the fuels are derived from natural gas. Neat alcohol fuels are at least 85 percent methanol, ethanol, and other alcohol. The exemption is scheduled to expire after December 31, 1992.	(2) Repeal excise tax exemptions after 1985.	(2) Same as President's proposal.
c. Duty on imported alcohol fuels	A 60-cents-per-gallon duty is imposed on alcohol imported into the United States for use as a fuel. The duty is scheduled to expire after December 31, 1992.	Retain duty on alcohol imported for use as a fuel.	Same as President's proposal.

Item	Present Law	President's Proposal	Possible Option
.. Targeted Jobs Tax Credit	A tax credit is available on an elective basis to employers of individuals from one or more of nine targeted groups. The nine groups consist of individuals who are either recipients of payments under means-tested transfer programs, economically disadvantaged (as measured by family income), or disabled. The credit generally is equal to 50 percent of the first $6,000 of qualified first year wages and 25 percent of the first $6,000 of qualified second year wages paid to a member of a targeted group. A credit equal to 85 percent of up to $3,000 of wages of any disadvantaged summer youth employees is also allowed. The employer's deduction for wages must be reduced by the amount of the credit. The credit is scheduled to expire as of December 31, 1985.	Allow the provision to expire as scheduled.	Same as President's proposal.

Item	Present Law	President's Proposal	Possible Option
. Corporate Tax Rates	Corporate taxable income is subject to tax under a 5-bracket graduated rate structure as follows: *Taxable Income* — *Rate* $25,000 or less .... 15 $25,000–$50,000 .... 18 $50,000–$75,000 .... 30 $75,000–$100,000 .... 40 Over $100,000 .... 46 An additional 5 percent tax is imposed on a corporation's taxable income in excess of $1 million, up to a total additional tax of $20,250. This results in elimination of the benefit of the graduated rate structure (in effect, payment of tax at a flat 46 percent rate) for income over $1,405,000. An alternative tax rate of 28 percent applies to a corporation's net capital gain if this results in a lower rate than under the graduated rate schedule.	Corporate income would be subject to tax under a 4-bracket graduated rate structure as follows: *Taxable Income* — *Rate* $25,000 or less .... 15 $25,000–$50,000 .... 18 $50,000–$75,000 .... 25 Over $75,000 .... 33 The graduated rates would be phased out for corporations with taxable income in excess of $140,000 by imposing an additional 5-percent tax on income between $140,000 and $345,000. Thus, corporations having taxable income of $345,000 or more would, in effect, pay tax at a flat 33 percent rate. The alternative tax on corporate net capital gain would remain at 28 percent. *Effective date.*—July 1, 1986 (income in taxable years that include July 1, 1986, would be subject to "blended" rates).	Retain present-law rate of 30 percent for $50,000–$75,000 bracket and provide 35 percent rate for income over $75,000. Corporate income would thus be subject to tax under a 4-bracket graduated rate structure as follows: *Taxable Income* — *Rate* $25,000 or less .... 15 $25,000–$50,000 .... 18 $50,000–$75,000 .... 30 Over $75,000 .... 35 An additional 5-percent tax would be imposed on income between $140,000 and $350,000. Thus, corporations having taxable income of $350,000 or more would, in effect, pay tax at a flat 35 percent rate. The alternative tax on corporate net capital gain would be repealed. Thus, corporate net capital gain would be taxed at regular corporate rates. *Effective date.*—The rate changes would be effective for taxable years beginning on or after January 1, 1986.

Item	Present Law	President's Proposal	Possible Option
Dividends Paid Deduction and Dividends :ceived Deduction			
1. Dividends paid deduction	(a) Corporations generally compute taxable income and are subject to a separate corporate level tax without deduction for dividends paid to shareholders. (b) Foreign shareholders of U.S. corporations generally are subject to 30-percent withholding tax on dividends; lower rate may be provided by treaty. Tax-exempt entities generally not taxable on dividends received, except in certain cases where tax-exempt entity owns debt-financed property.	Domestic corporation would receive deduction for 10 percent of dividends paid out of corporate earnings that have been subject to tax after the general effective date. Additional compensatory withholding tax equal to the tax benefit received from the deduction would be imposed on foreign shareholders not protected by treaty. No special rules for dividends paid to tax-exempt shareholders. *Effective date.*—Generally, taxable years beginning after December 31, 1986, with special rule for dividends paid after that date in taxable years beginning before January 1, 1987.	Phase in President's proposal over 10 years beginning in 1987; deduction would be 1 percent for taxable years beginning after January 1, 1987, increasing 1% each year up to 10 percent for taxable years beginning after January 1, 1996. Also, modify President's proposal as follows: (a) Treat deductible portion of dividends paid to tax-exempt shareholders owning 5 percent or more of a corporation's stock as taxable "unrelated business income" to the shareholder. This would ensure that corporate earnings are not completely exempted from tax to the extent a corporation has a substantial tax-exempt shareholder. (b) Impose compensatory withholding tax on dividends paid after December 31, 1987, to foreign shareholders otherwise protected by treaty, except where the foreign country grants roughly equivalent relief from a two-tier tax to U.S. shareholders.
2. Dividends received deduction	(a) Corporations generally are entitled to an 85 percent dividends received deduction; 100 percent dividends received deduction for dividends from certain affiliates. (b) Dividends received deduction is limited for dividends from foreign corporation, based on extent of foreign corporation's earnings subject to U.S. tax. No dividends received deduction for dividends on stock not held with substantial risk of loss for a specified period. Deduction is limited for dividends on certain "debt financed portfolio stock."	Dividends received deduction for corporations modified, so that 90 percent dividends received deduction available for dividends paid out of earnings that have been subject to corporate tax and 100 percent dividends received deduction available for dividends paid out of earnings that have not been subject to corporate tax. Extent of stock ownership would not matter. *Effective date.*—Generally, taxable years beginning after December 31, 1986, with special rule for dividends paid after that date in taxable years beginning before January 1, 1987.	Generally, phase in President's proposal to correspond to phase in of dividends paid deduction. However, retain 85 percent dividends received deduction for dividends eligible for 85 percent deduction under present law; reduce to 75 percent over 10 years to correspond to payor's dividends paid deduction.

Item	Present Law	President's Proposal	Possible Option
Dividend Exclusion for Individuals	First $100 of qualifying dividends received by an individual ($200 by married couple filing joint return) excluded from income. Generally, qualifying dividends are dividends from domestic corporations.	Dividend exclusion for individuals would be repealed. *Effective date.*—Taxable years beginning after December 31, 1985.	Follow the President's proposal, but clarify that the exclusion is repealed for dividends received in taxable years beginning after December 31, 1985, regardless of when paid by the corporation.
Treatment of Stock Redemption Payments	In general, a corporation may not deduct the cost of repurchasing its own stock from shareholders. Some corporations have taken the position that stock redemption payments for the purpose of preventing a hostile takeover of the corporation (so-called "greenmail" payments) are deductible as ordinary business expenses.	None.	Provide that no portion of payments by a corporation in redemption of its own stock is deductible.

Item	Present Law	President's Proposal	Possible Option
. Special Limitations on Net Operating Loss (NOL) Carryovers			
1. General approach	There is no consistent approach. If the limitations apply, NOL carryovers are reduced or eliminated, depending on whether the transaction takes the form of a tax-free reorganization or a taxable purchase, respectively.	None.	The new owners of a loss corporation would not be able to use a NOL carryover more rapidly than it would be used if there were no change in ownership. In general, if the limitations apply, the earnings against which a NOL carryover could be deducted—and not the NOL carryover itself—would be limited.
2. Taxable purchases	The limitations apply if there is a purchase of 50 percent or more of the stock of a loss corporation, unless the business-continuation requirement in below, is satisfied.	None.	The limitations would apply after change in ownership of more than 50 percent of the value of a loss corporation's equity.
a. Effect of change of ownership	NOL carryovers are eliminated.	None.	The earnings available for offset in each post-acquisition year would be limited to a prescribed rate of return on the value of the loss corporation amount of taxable income the loss corporation would have earned had no acquisition occurred (tentatively set at the tax-exempt bond rate for long-term bonds).
b. Period for testing ownership changes	Two years.	None.	Three years.
c. Shareholders taken into account	Ten largest shareholders.	None.	All 5% or greater shareholders, with all less-than-5% shareholders treated as one 5% shareholder.
d. Constructive ownership rules	The constructive ownership rules of section 318 apply, so that a purchase from one whose stock would be attributed to the purchaser would be disregarded, except that the attribution rules for corporations and shareholders apply without regard to the 50-percent limitations in section 318.	None.	Same as present law, except a corporation would be treated as owning stock owned by a shareholder in the proportion that the value of the shareholder's stock in the corporation bears to the value of all outstanding stock, and stock underlying an option would be attributed to the person whose ownership would cause the limitations to apply.
e. Business continuation requirement	NOL carryovers are eliminated if the loss corporation fails to continue the conduct of a trade or business that was conducted before the change in ownership.	None.	NOL carryovers are eliminated unless the loss corporation satisfises the business-continuation requirement during the two-year period following the acquisition.

Item	Present Law	President's Proposal	Possible Option
3. Tax-free reorganizations	The limitations apply if the loss-corporation shareholders' continuing interest is less than 20 percent.	No provision.	Apply the same rule that applies to taxable purchases, except the rule for less-than-5% shareholders would not apply.
a. Effect of change of ownership	NOL carryovers are reduced by 5 percent for each 1 percent by which the continuing interest is below 20 percent.	No provision.	Apply the same rule that applies to taxable purchases.
b. Business continuation requirement	No general requirement that business be continued, though in certain cases some continuity of business enterprise may be required for tax free reorganization treatment. (See also 4., below.)	No provision.	Apply the same rule that applies to taxable purchases.
4. Tax-motivated transactions	Under section 269, NOL carryovers are subject to disallowance following acquisition of 50 percent of stock in a corporation or a tax-free acquisition of assets, if the principal purpose of the acquisition was tax avoidance.	No provision.	Retain present law.
5. Consolidated returns	If an acquired corporation joins the acquiring corporation in the filing of a consolidated tax return by an affiliated group, the use of the acquired corporation's pre-acquisition NOLs is limited to the acquired corporation's income. A similar rule applies if control is acquired of the common parent of an affiliated group.	No provision.	Retain present law.
6. Built-in gains and losses	The special limitations do not apply to built-in gains and losses.	No provision.	Apply the special limitations to built-in gains and losses (including built-in deductions), subject to a 15-percent de minimis rule. Provide a presumption that there is a built-in loss where a controlling stock interest is acquired for a price that is substantially less than the asset basis.

Item	Present Law	President's Proposal	Possible Option
7. Stock-for-debt exception	Creditors are not treated as shareholders for purposes of the rule that applies to taxable purchases. Creditors who receive stock in Title 11 or certain other insolvency reorganizations are treated as continuing shareholders.	No provision.	Stock received in exchange for a creditor's claim would not be treated as a continuing stock interest.
8. Other tax attributes	Similar rules apply to the carryover of credits and capital losses.	No provision.	Similar rules would apply to credits and capital losses, except foreign tax credit carryovers would be limited pursuant to regulations.
9. Measurement of beneficial ownership	Ownership changes are measured by reference to all shares, except nonvoting stock that is limited and preferred as to dividends.	No provision.	Ownership changes would be measured by reference to "participating stock" (i.e., stock that represents an interest in a corporation's growth potential).
10. Passive assets	No specific rule, although, under the rule for taxable purchases, the loss corporation must hold assets used in a trade or business.	No provision.	If at least one-third of loss corporation's assets consist of passive assets, the income against which NOL carryovers could be used would be subject to reduction.
11. Capital contributions	No specific provision.	No provision.	The value of the loss corporation's equity would be reduced by the value of capital contributions made within 3 years of the acquisition date.
12. Effective date			*Effective date.*—Acquisitions on or after January 1, 1986, and reorganizations pursuant to a plan adopted on or after January 1, 1986.

Item	Present Law	President's Proposal	Possible Option
F. Employee Stock Ownership Plans (ESOPs)			
1. ESOPs as employee benefit plans			
a. Investment in employer securities	ERISA imposes a limit on the percentage of plan assets that may be invested in qualifying employer securities and qualifying real property.	Under the proposal, no qualified plan could hold more than ten percent of plan assets in qualifying employer securities and qualifying employer real property.	Retain present law relating to qualified plans.
	For a pension plan (either defined benefit or money purchase), the limit is ten percent. For a profit sharing or stock bonus plan, the ten percent limit may be increased to an amount specified by the plan, up to 100 percent.	Under the proposal, a new Employee Stock Ownership Trust (ESOT) would be designed to invest primarily in employer securities.	Do not adopt the ESOT proposal.
	An Employee Stock Ownership Plan (ESOP) (either a stock bonus plan or a combination stock bonus and money purchase pension plan) must be invested primarily in employer securities. ESOPs are subject to special qualification requirements in addition to those generally applicable to qualified plans.	Under the proposal, any employer with 15 or more employees would be eligible to create a qualified ESOT. If the ESOT qualifies, then (1) the trust would be exempt from income tax, (2) employers would be allowed deductions (of up to 25 percent of compensation) for principal payments made on a securities acquisition loan, or for amounts contributed to an ESOT; even though participants would not be currently even though participants would not be currently taxed on such contributions, and (3) participants would not be taxed until the employer securities were sold or exchanged. Parallel rules would be provided for certain nonleveraged ESOTs to which the employer had committed a stream of contributions. An eligible securities acquisition loan would require either (a) annual principal payments not greater than 20 percent or less than 8.3 percent of the original principal balance, or (b) equal annual payments and a term of ten years or less. The ESOT trust agreement would be required to provide that (1) the securities distributed or allocated during the year, and (2) dividends on undistributed and unallocated securities, be apportioned among all employees (or, those employees with 1000 hours of service) on the basis of each employee's compensation for the year not in excess of $50,000.	

Item	Present Law	President's Proposal	Possible Option
b. Voting rights	A stock bonus or money purchase pension plan (including an ESOP) maintained by an employer whose securities are not publicly traded must provide the full pass-through of voting rights to participants with respect to securities allocated to such participants on major corporate issues if the plan holds more than ten percent of its assets in employer securities. In addition, an ESOP maintained by an employer that has registration-type securities must provide pass-through voting with respect to allocated securities on any issue.	Under the proposal, the new ESOT would be required to provide pass-through voting (1) on all issues with respect to allocated securities and (2) on major corporate issues with respect to unallocated securities.	Require an ESOP to pass through voting rights on allocated securities on all issues, and to pass through voting rights on unallocated securities on all major corporate issues.
c. Special ESOP deduction limits	If an employer maintains an ESOP, contributions applied to the payment of principal on a securities acquisition loan are deductible up to 25 percent of covered compensation.	The proposal would repeal the increased ESOP limits applicable to qualified plans.	Retain the present law limit with respect to the deduction of interest paid on a securities acquisition loan.
	In addition, an employer's contributions to an ESOP that are applied to the payment of interest on a securities acquisition loan are deductible without regard to an annual percentage of compensation limit.	The proposal would permit a deduction not to exceed 25 percent of covered compensation for employer payments of principal on a securities acquisition loan. Nondeductible payments could be carried forward and deducted in subsequent years, subject to the same 25 percent limit. This 25 percent deduction limit would be in addition to any deductions permitted for employer contributions to a qualified plan.	Clarify that the special 25 percent of compensation limit only permits an employer maintaining a stock bonus ESOP to deduct principal payments of up to 25 percent of compensation without adopting a money purchase pension plan and does not increase the limit otherwise applicable to an employer who maintains an ESOP consisting of a combination stock bonus and money purchase pension plan.
d. Overall limits on contributions	The usual dollar limit on annual additions ($30,000) is increased to the lesser of (1) $60,000 or (2) the amount of employer securities contributed to, or acquired by, the plan. In addition, deductible ESOP contributions applied by the plan to the payment of interest on a securities acquisition loan, as well as forfeitures of certain employer securities, may be disregarded in applying this limit. These increased limits apply only if the ESOP provides that no more than one-third of the employer contributions for the year are allocated to the group of employees consisting of officers, shareholders and highly compensated employees.	The proposal would repeal the increased ESOP limits applicable under qualified plans. Allocations of employer securities under an ESOT would be permitted without regard to the qualified plan limits on annual additions.	Retain the special ESOP limits of present law.
e. ESOP tax credits	An electing employer is allowed an income tax credit for contributions to a payroll-based tax credit ESOP. The credit is limited to one-half of one percent of compensation paid or accrued in 1985, 1986, or 1987. No credit would be allowed after 1987.	The proposal would allow the payroll-based tax credit to expire after 1987, as scheduled under present law.	Repeal the payroll-based tax credit, effective for compensation paid or accrued after December 31, 1985.

Item	Present Law	President's Proposal	Possible Option
f. Distribution restrictions	*Put options.*—A participant in an ESOP generally must have the right to demand distribution of employer securities rather than cash and, if the securities are not readily tradeable, the employer must provide a put option.	*Put options.*—The proposal would repeal the special put option rules relating to qualified plans.	Expand the present law 84 month rule to all ESOPs. In addition, grant the employees the right to demand a distribution of employer securities at the end of the 84 month period, subject to the present law put option. In the case of a closely held employer, permit the employer to have a right of first refusal with respect to the sale of any securities previously distributed from an ESOP.
	Distribution restrictions.—Distributions from an ESOP generally must satisfy the distribution rules applicable to stock bonus or money purchase plans. In addition, employer securities allocated to a participant's account under a tax-credit ESOP generally may not be distributed before the end of 84 months.	*Distribution restrictions.*—The new ESOT generally would be required to distribute annually that portion of the securities held by the ESOT equal in value to the scheduled principal payments on the securities acquisition loan, as well as dividends paid on allocated and unallocated stock. Alternatively, the ESOT could retain nominal ownership of the allocated securities provided the employees had all rights of direct ownership. In addition, the employer would be required to grant employees the right to put distributed or allocated securities within three years after receipt or allocation and for a specified period every year thereafter until the year following the employee's separation from service. The 84-month rule would be repealed with respect to qualified plans.	
g. Effective date		*Effective date.*—The President's proposal would generally apply to securities acquisition loans made after December 31, 1985. The treatment of additional contributions made pursuant to loans outstanding on December 31, 1985, would continue to be governed by existing law.	*Effective date.*—Same as the President's proposal.
2. Incentives for ESOP financing			
a. Deduction for dividends paid	An employer may deduct the amount of any dividends paid in cash with respect to employer-securities held by an ESOP and allocated to participants' accounts, provided the dividends are paid out currently to participants and beneficiaries.	The proposal would modify the provision providing a deduction for dividends paid (1) by permitting the deduction only with respect to employer securities held by the new Employee Stock Ownership Trust (ESOT) (and not an ESOP); (2) by making the deduction available with respect to dividends paid on all allocated and unallocated employer securities held by the ESOT; and (3) by conditioning the deduction on the employer's making an additional nondeductible payment (equal to the resulting tax savings) to employees receiving the dividends.	Repeal the present law provision.

Item	Present Law	President's Proposal	Possible Option
2. Incentives for ESOP financing—Cont.			
b. Exclusion of interest earned on securities acquisition loans	A bank, insurance company, or a corporation actively engaged in the business of lending money may exclude from gross income 50 percent of the interest received on loans to a leveraged ESOP, the proceeds of which are applied by the plan to acquire employer securities.	The proposal would apply the 50-percent interest exclusion to transactions involving ESOTs rather than ESOPs.	Repeal the present law provision.
c. Tax-deferred rollover of gain derived from sales of stock to an eligible employee organizations	An individual may elect to defer recognition of gain on the sale of certain qualified securities to an ESOP or eligible worker-owned cooperative to the extent that the proceeds are reinvested in qualified replacement property within a replacement period.	The proposal would permit an individual to elect to defer recognition with respect to qualifying sales made to an ESOT rather than an ESOP or eligible worker-owned cooperative.	Repeal the present law provision.
d. Payment of estate tax by an employee organization	If qualified employer securities are (1) acquired from a decedent by an ESOP or an eligible worker-owned cooperative, (2) pass from a decedent to an ESOP or worker-owned cooperative or (3) are transferred by the decedent's executor to an ESOP or worker-owned cooperative, then the executor is relieved of estate tax liability to the extent the ESOP or cooperative is required to pay the liability.	The proposal would repeal this provision.	Same as the President's proposal.
e. Effective date		*Effective date.*—The proposals would be effective for dividends paid, loans made, sales occurring, or decedents dying after December 31, 1985.	*Effective date.*—Same as the President's proposal.

IV. TAX SHELTERS

Item	Present Law	President's Proposal	Possible Option
At-Risk Rules	The loss limitation at-risk rules limit the losses in excess of income with respect to an activity, which individuals and closely held corporations may deduct, to the amount the taxpayer has actually invested in the activity, including borrowed amounts to the extent the taxpayer is personally liable to repay or has pledged other non-financed property (except property used in the activity) as security, and has not borrowed the funds from a person with an interest in the activity other than as a creditor. Closely held corporations engaged in certain equipment leasing activities and in certain active business activities are excepted from the rules. The at-risk rules apply to all activities except the holding of real estate.	The exception for the activity of holding real estate would be repealed. *Effective date.*—The proposal would be effective with respect to losses attributable to property acquired after December 31, 1985.	Same as President's proposal.
Investment Interest 1. **General limitation**	The deduction for investment interest of noncorporate taxpayers is limited to the sum of $10,000, plus net investment income, plus certain deductible expenditures in excess of rental income from net lease property. Interest deductions not allowed due to this limitation carry over to future years.	The deduction for all nonbusiness interest of noncorporate taxpayers would be limited to the sum of: interest on debt secured by the taxpayer's principal residence to the extent of its value, plus $5,000, plus net investment income, plus certain deductible expenditures in excess of rental income from net lease property.	Modify the President's proposal to provide that the deduction for all nonbusiness interest (in excess of net investment income plus certain deductible expenditures in excess of rental income from net lease property) of noncorporate taxpayers is limited to the greater of (i) interest on debt secured by the taxpayer's principal residence to the extent of its fair market value, or (ii) $20,000. Housing cooperatives may qualify under (i) subject to appropriate limitations.
2. **Interest subject to limitation**	Investment interest subject to the limitation is interest on debt to purchase or carry investment property. The treatment of interest expense to acquire stock of S corporations or an interest in limited partnerships is not entirely clear under present law.	Nonbusiness interest subject to the limitation is broader than present-law investment interest, and would mean all interest not incurred in a trade or business, including the taxpayer's share of interest of S corporations in whose management he does not actively participate, and the taxpayer's share of interest expense of limited partnerships in which he is a limited partner.	Same as the President's proposal, except that investment interest also includes the taxpayer's share of interest expense of certain trusts and other entities in which he is a limited entrepreneur.

Item	Present Law	President's Proposal	Possible Option
3. Investment income defined	Net investment income means investment income net of investment expense. Investment income means interest, dividends, rents, royalties, short-term capital gain from disposition of investment property and depreciation recapture not from conduct of a trade or business. Investment expense means deductible investment expenses (other than interest), except that straight-line (not accelerated) depreciation over useful life, and cost (not percentage) depletion are used in calculating investment expenses.	Investment income is expanded to include the same income items as present law plus the taxpayer's share of all income of S corporations in whose management the taxpayer does not actively participate and his share of all income of limited partnerships in which the taxpayer is a limited partner. Investment expense would be determined the same as under present law, except that the Treasury report RCRS depreciation schedule would be substituted for present-law straight-line depreciation.	Same as President's proposal except that investment income also includes the taxable portion of long-term capital gain and the taxpayer's share of income of certain trusts and other entities in which he is a limited entrepreneur; and investment expense also includes the depreciation and depletion the taxpayer actually utilized rather than RCRS depreciation or cost depletion, so that the net investment income portion of the limitation reflects the taxpayer's actual net investment income subject to tax.
4. Net leases	Property subject to a net lease is treated as an investment, unless the trade or business deductions exceed 15 percent of the rental income.	Same as present law.	Modify President's proposal to provide that, to the extent the taxpayer performs personal services in lieu of incurring deductible expenses with respect to directly owned leased property in certain circumstances, the value of such services may be included with the actual trade or business deductions in determining whether such deductions exceed 15 percent of the rental income.
5. Rental property	Interest on rental property used for both business and personal purposes (e.g., a vacation home, in some circumstances) is not subject to the interest limitation. Expenses of such rental property are generally allocated to business use in the ratio of the number of days the property is rented at a fair rental to the number of days the property is used in the taxable year.	A portion of interest on business rental property used by the taxpayer for both business and personal purposes (e.g., a vacation home in some circumstances) is treated as business interest not subject to the limitation, in the ratio of the number of days the property is rented at a fair rental to the number of days in the taxable year.	Retain present law regarding allocation of expenses of rental property used for both business and personal purposes, and apply the present law allocation ratio, in lieu of the ratio of the President's proposal, to determine the portion of business interest subject to the limitation.
6. Effective date		*Effective date.*—Subject to two phase-in rules, the limitation would be effective for interest paid or incurred in taxable years beginning on or after January 1, 1986, regardless of when the obligation was incurred. The first phase-in rule is that the $10,000 limit under present law would be reduced to $5,000 for taxable years beginning on or after January 1, 1988. The second phase-in rule is that interest not subject to the limitation under present law, but which would be subject to the expanded limitation, would become subject to the limitation ratably (10 percent per year) over 10 years commencing with taxable years beginning in 1986. Thus, 100 percent of interest subject to the expanded limitation would have become subject to it in taxable years commencing in 1995.	*Effective date.*—Generally the same as the President's proposal, except that the first phase-in rule does not apply.

V. MINIMUM TAX

Item	Present Law	President's Proposal	Possible Option
Individual Minimum Tax			
1. Structure	An alternative tax, applying to a broader income base and at a lower rate than the regular tax, and payable to the extent in excess of regular tax liabilities.	Same as present law.	Same as President's proposal.
2. Rate	20 percent.	Same as present law.	25 percent.
3. Exemption amount	$40,000 for joint returns, $30,000 for singles, $20,000 for marrieds filing separately.	The sum of the following: (1) $15,000 for joint returns, $12,000 for heads of household, $10,000 for singles, $7,500 for marrieds filing separately; (2) the first $10,000 of preferences; and (3) the taxpayer's personal exemptions.	Retain present law.
4. Tax preferences			
a. Dividends excluded from gross income (up to $100 per person, $200 for joint returns)	Treated as a preference (added to taxable income).	Repealed for regular tax purposes.	Same as President's proposal.
b. Accelerated depreciation on real property	Excess over straight-line depreciation is a preference.	Same as present law for real property placed in service before 1986. For real property placed in service beginning in 1986, excess over Treasury I depreciation is a preference.	For property placed in service after 1985, treat as a preference the excess of incentive depreciation over nonincentive depreciation. Same as President's proposal for property placed in service before 1986.
c. Accelerated depreciation on personal property	Solely for leased personal property, excess over straight-line depreciation is a preference. Rule also applies to personal holding companies.	Same as present law for property placed in service before 1986. For leased personal property placed in service beginning in 1986 (applying also to personal holding companies) excess over Treasury I depreciation is a preference.	For all property placed in service after 1985, treat as a preference the excess of incentive depreciation over nonincentive depreciation. Same as President's proposal for property placed in service before 1986.
d. Expensing of intangible drilling costs	Excess over 10-year amortization (or cost depletion), to the extent in excess of net oil and gas income, is a preference. Rule also applies to personal holding companies.	8-percent of intangible drilling costs treated as a preference.	Retain present law, but without the offset for net oil and gas income.
e. 60-month amortization on certified pollution control facilities	Excess over depreciation otherwise allowable is a preference.	Same as present law for property placed in service before 1986. The provision is repealed for regular tax purposes, effective in 1986.	Same as President's proposal.
f. Expensing of mining exploration and development costs	Excess over 10-year amortization is a preference. Rule also applies to personal holding companies.	Same as present law.	Same as President's proposal.

Item	Present Law	President's Proposal	Possible Option
g. Expensing of circulation expenditures (for newspapers, magazines, etc.)	Excess over 3-year amortization is a preference. Rule also applies to personal holding companies.	Not a preference.	Retain present law.
h. Expensing of research and experimentation expenditures	Excess over 10-year amortization is a preference. Rule also applies to personal holding companies.	Same as present law.	Treat excess over 5-year (instead of 10-year) amortization as a preference.
i. Percentage depletion	Excess over adjusted basis of the depletable property is a preference.	Same as present law for property placed in service before 1986. For property placed in service beginning in 1986, excess over cost depletion is a preference.	To the extent percentage depletion is retained for regular tax purposes, retain present law for all depletable property.
j. Net capital gain deduction	Treated as a preference.	Same as present law.	Same as President's proposal.
k. Incentive stock options	Excess of fair market value of stock over exercise price is a preference.	Same as present law.	Same as President's proposal.
l. Tax-exempt interest	Not a preference.	Not a preference. For regular tax purposes, exemption would be repealed for newly issued securities other than governmental obligations.	Treat as a preference interest on any newly issued nongovernmental obligations that continue to be exempt. Refundings of pre-1986 bonds not a preference.
m. Excludable income earned abroad by U.S. citizens	Not a preference.	Not a preference.	Treat as a preference.
n. Completed contract method of accounting	Not a preference.	Not a preference.	To the extent completed contract method is retained for regular tax purposes, treat benefit, compared to use of percentage of completion method, as a preference.
o. Net loss from passive investment activities	Not a preference.	Not a preference.	To the extent deductible under regular tax, treat as a preference the net loss with respect to trade or business activities (including the production of rental or royalty income) in which the taxpayer did not materially participate in management or provide substantial personal services.
5. Itemized deductions	Allowed only for casualty and theft losses, gambling losses to extent of gambling gains, charitable deductions, medical deductions (to the extent in excess of 10 percent of adjustment gross income), interest expenses (restricted to housing interest plus net investment income), and certain estate tax.	Allowed for all itemized deductions retained under the Administration proposal, except (i) interest in excess of the sum of housing interest and net investment income; and (ii) for charitable contributions of appreciated property, the amount of untaxed appreciation allowed as a regular tax deduction.	Retain present law, except follow President's proposal with respect to charitable contributions of appreciated property.

V. MINIMUM TAX—(Continued)

Item	Present Law	President's Proposal	Possible Option
6. Regular tax elections	Taxpayers generally can elect to have minimum tax rules for measuring a particular item apply for regular tax purposes.	No election rules are stated.	For all preferences, allow election to have minimum tax rule apply for regular tax purposes.
7. Adjustments in other years when taxpayer pays minimum tax	No provision.	No provision.	Amount of minimum tax liability can be allowed as a carryforward credit against regular tax liability.
8. Incentive credits	Not allowed against minimum tax. Credits that do not benefit the taxpayer due to minimum tax can be used as credit carryovers against regular tax.	Not allowed against minimum tax. No carryover rules are stated.	Same as President's proposal, but use present law rules for credit carryovers.
9. Foreign tax credit	Allowed against minimum tax (under limits similar to those applying under regular tax).	Rule is not stated.	Retain present law.
10. Net operating losses (NOLs)	Allowed against minimum taxable income. For years after 1982, minimum tax NOLs are reduced by the items of tax preference.	Rule is not stated.	Retain present law.
11. Effective date		Taxable years beginning after December 31, 1985.	Same as President's proposal.

Item	Present Law	President's Proposal	Possible Option
B. Corporate Minimum Tax			
1. Structure	An add-on tax, equalling a percentage of certain preferences minus regular tax paid.	An alternative minimum tax, applying to a base of regular taxable income plus preferences, and payable to the extent in excess of regular tax liability.	Same as President's proposal.
2. Rate	15 percent.	20 percent (same as for individuals).	25 percent.
3. Exemption amount	The greater of $10,000 or the taxpayer's regular tax liability.	$15,000, plus the first $10,000 of preference income.	$40,000 (same as for individuals filing joint returns under present law).
4. Tax preferences			
a. Accelerated depreciation on real property	Excess over straight-line depreciation is a preference.	Same as present law for property placed in service before 1986; for property placed in service beginning in 1986, excess over Treasury I depreciation is a preference.	For property placed in service after 1985, treat as a preference the excess of incentive depreciation over nonincentive depreciation. Same as President's proposal for property placed in service before 1986.
b. Capital gain preference	Preference (application of a lower rate) does not apply for minimum tax purposes.	Same as present law.	Same as President's proposal.
c. 60-month amortization of certified pollution control facilities	Excess over depreciation otherwise applying is a preference.	Same as present law for facilities placed in service before 1986; amortization rule repealed for regular tax purposes beginning in 1986.	Same as President's proposal.
d. Bad debt reserve deduction for financial institutions	Excess of deduction over amount allowable under the experience method is a preference.	Bad debt reserve deduction is repealed for regular tax purposes.	Same as President's proposal.
e. Percentage depletion	A preference to the extent in excess of basis.	Same as present law for property placed in service before 1986; for property placed in service beginning in 1986, excess over cost depletion is a preference.	To the extent percentage depletion is retained for regular tax purposes, retain present-law rule for all depletable property.
f. Accelerated depreciatation on personal property	Not a preference except for personal holding companies (PHCs). For PHCs, applying solely to leased personal property, excess over straight-line depreciation is a preference.	Same as present law for property placed in service before 1986. For leased property placed in service by a PHC beginning in 1986, excess over Treasury I depreciation is a preference. For corporations generally and all personal property, the lesser of (i) excess over Treasury I depreciation, and (ii) 25 percent of the corporation's net interest expense is a preference.	For all corporations and all personal property placed in service after 1985, treat as a preference the excess of incentive depreciation over nonincentive depreciation. Same as President's proposal for property placed in service before 1986.
g. Expensing of mining exploration and development costs	Solely for PHCs, excess over 10-year amortization is a preference.	Treat as a preference for all corporations.	Same as President's proposal.

Item	Present Law	President's Proposal	Possible Option
h. Expensing of intangible drilling costs	Solely for PHCs, excess over 10-year amortization (or cost depletion), to the extent in excess of net oil and gas income, is a preference.	For all corporations, 8 percent of intangible drilling costs is treated as a preference.	Treat as a preference for all corporations. Use present law rule, but without net income offset, to measure the preference.
i. Expensing of circulation expenditures (by newspapers, magazines, etc.)	Solely for PHCs, excess over 3-year amortization is a preference.	Not a preference.	Retain present law.
j. Expensing of research and experimentation expeditures	Solely for PHCs, excess over 10-year amortization is a preference.	Same as present law.	Treat as a preference for all corporations; reduce amount of preference to the excess over 5-year amortization.
k. Tax-exempt interest	Not a preference.	Not a preference; for regular tax purposes, only governmental obligations remain exempt.	Treat as a preference for any nongovernmental obligations that remain exempt. Refundings of pre-1986 bonds not a preference.
l. Excludable foreign sales corporation (FSC) income	Not a preference.	Not a preference.	Treat as a preference.
m. Benefit of completed contract method of accounting	Not a preference.	Not a preference.	To the extent completed contract method is retained for regular tax purposes, treat difference from percentage of completion method as a preference.
n. Charitable contibutions of appreciated property	Not a preference.	Amount of untaxed appreciation claimed as a deduction is a preference.	Same as President's proposal.
5. Regular tax elections	No provision.	No provision.	Permit elections to apply minimum tax rules to regular tax treatment of any item.
6. Adjustment in other years when taxpayer pays minimum tax	No provision.	No provision.	Amount of minimum tax liability can be allowed as a carryforward credit against regular tax liability in other years.
7. Incentive credits	Not allowed against minimum tax. Credits that do not benefit the taxpayer due to minimum tax can be used as credit carryovers against regular tax.	Not allowed against minimum tax. No carryover rules are stated.	Apply present law rule under alternative minimum tax on individuals (not allowed against minimum tax but can be carried over).
8. Foreign tax credit	Allowed in calculating add-on tax.	Rule is not stated.	Apply present-law rule under alternative minimum tax on individuals (allowed subject to limits similar to those under regular tax).

V. MINIMUM TAX—(Continued)

Item	Present Law	President's Proposal	Possible Option
9. Net operating losses (NOLs)	Allowed in calculating add-on tax.	Rule is not stated.	Allow against minimum taxable income. For years after 1982, reduce minimum tax NOLs by the items of tax preference under present law. For years after 1985, reduce minimum tax NOLs by all newly enacted items of tax preference.
10. Estimated tax payments	Corporations are not required to make estimated tax payments with respect to minimum tax liability.	No provision.	Require that estimated tax payments be made with respect to minimum tax liability.
11. Effective date		Taxable years beginning after December 31, 1985.	Same as President's proposal.

VI. FOREIGN TAX PROVISIONS

Item	Present Law	President's Proposal	Possible Option
Foreign Tax Credit			
1. Foreign tax credit limitation	The foreign tax credit is determined on an "overall" basis: a taxpayer adds up its net income and net losses from all sources outside the United States and calculates one aggregate limitation based on the total. The limitation equals the total amount of U.S. tax that would be owed on the taxpayer's total foreign source income.	Determine the foreign tax credit limitation on a per country basis instead of on an overall basis. That is, a taxpayer could credit taxes paid on income derived from a particular country only up to the amount of U.S. tax that would be owed on *that* income.	Retain the overall limitation of present law.
	Overall foreign tax credit limitations are calculated separately for certain categories of income that frequently bear either high (e.g., oil income) or low (e.g., FSC dividends) rates of foreign tax or that can easily be earned in low-tax countries rather than in the United States in order to inflate the foreign tax credit limitation.	Generally retain the present law separate limitations, but apply them on a country-by-country basis if the per country limitation is adopted. The application of the separate limitation for interest would be extended to certain other types of income. Dividends generally would be subject to the various separate limitations in proportion to the types of income out of which the dividends were paid.	As an alternative to the President's per country limitation proposal, replace the separate limitation for interest income with a separate limitation for low-tax income. Low-tax income generally would include income received either directly or through a foreign subsidiary that is defined under the Code's anti-tax haven rules as foreign personal holding company income, insurance income, or foreign base company shipping income. (Those categories of low-tax income would be modified by the possible changes to the rules concerning tax-haven income discussed in C., below.) Look-through rules would be applied to separate limitation items received from certain related parties, to determine whether such items are properly treated as low-tax income.
	Foreign taxes in excess of the foreign tax credit limitation may be carried back two years and then carried forward five years.	If the per country limitation is adopted, extend the foreign tax credit carryover period from five to 10 years.	Retain present law.
	The foreign tax credit is elective. Taxpayers may deduct foreign income taxes if they prefer. However, a taxpayer that elects to credit any foreign income taxes paid in a particular year may not deduct other foreign income taxes paid that year.	If the per country limitation is adopted, permit taxpayers to make the election to deduct or to credit foreign taxes on a country-by-country basis.	Retain present law.
		Effective date.—Generally, taxable years beginning after 1985. The 10-year carryover period would apply only to excess credits generated after January 1, 1986.	*Effective date.*—Generally, taxable years beginning after 1985.

Item	Present Law	President's Proposal	Possible Option
2. Creditability of "in lieu of" taxes	The foreign tax credit is available only for income, war profits, and excess profits taxes paid to a foreign country or a U.S. possession and for certain taxes imposed in lieu of them. Under Treasury regulations, a foreign levy generally is a creditable tax in lieu of an income tax only if the levy is a tax and is a substitute for, rather than an addition to, a generally imposed income tax. TEFRA added a comparability requirement to the Code's special foreign tax credit rules for taxes on foreign oil and gas income, allowing a credit only if the amount paid is comparable to the amount that would have been paid under the foreign country's general income tax.	None.	As an alternative to the President's per country limitation proposal, treat a foreign levy imposed on interest paid to banks and other financial institutions as a creditable "in lieu of" tax only to the extent of the amount of the general income tax of the levying country that would otherwise be imposed. This would limit the U.S. tax credit that banks and other lenders could receive for high foreign withholding taxes on interest. *Effective date.*—The change would apply to foreign taxes paid in taxable years beginning after 1985.
3. Effect of losses on foreign tax credit	Under the overall foreign tax credit limitation, a taxpayer first uses a net loss incurred in any foreign country to reduce its income from other foreign countries. If a taxpayer's net foreign losses subject to one separate limitation exceed its foreign income subject to that limitation, the excess reduces the taxpayer's U.S. source taxable income.	If the per country limitation is adopted, a net loss incurred in any foreign country would reduce taxable income earned in all other countries, including the United States, in proportion to the shares of worldwide taxable income of each of those other countries.	Generally retain present law, but specify that foreign source losses will first reduce foreign source income subject to other separate limitations before they reduce U.S. income. When income is later earned in the loss basket, it will be treated as income of the type previously offset by the loss.
	Oil and gas extraction losses incurred abroad are treated separately from other foreign losses so that the rules segregating oil and gas income (which often bears an abnormally high rate of tax abroad) for foreign tax credit limitation purposes can be effectively applied.	If the per country limitation is adopted, the separate rules governing the treatment of foreign oil and gas extraction losses would be repealed.	Retain present law, subject to the modification described immediately above.
	An overall U.S. loss first reduces foreign income earned in the loss year and hence precredit U.S. tax in that year.	An overall U.S. loss would continue to reduce foreign income. If the per country limitation is adopted, the U.S. loss would be prorated against income earned by the taxpayer in different foreign countries in proportion to the shares of worldwide taxable income of each of the countries. In addition, if a per country limitation is adopted, the proposal would add an overall U.S. loss recapture rule. Under this rule, a portion of U.S. income earned after an overall U.S. loss year would be treated as foreign income.	Retain present law.
		Effective date.—Generally, taxable years beginning after 1985. Pre-effective date overall foreign losses would be recaptured from post-effective date income under the pre-effective date foreign loss recapture rules.	*Effective date.*—The changes would be effective with respect to losses incurred in taxable years beginning after 1985.

Item	Present Law	President's Proposal	Possible Option
4. Deemed-paid credit	A U.S. corporation that owns at least 10 percent of a foreign corporation's voting stock and that has dividend income from the foreign corporation may generally take a "deemed-paid" credit for a share of the foreign taxes that the foreign corporation paid on the earnings out of which the dividend is paid. A similar credit applies when a 10 percent U.S. corporate shareholder includes in income a portion of a controlled foreign corporation's undistributed earning under subpart F. A dividend or subpart F inclusion is considered paid first from earnings and profits of the current year and then from accumulated profits of each preceding year. Actual distributions made in the first 60 days of a taxable year are treated as made from the prior year's earnings and profits. Earnings and profits may be computed in a different manner for actual dividend distributions than for subpart F inclusions.	A U.S. corporation's share of foreign taxes paid by a foreign corporation would depend on the percentage of the foreign corporation's multi-year pool of accumulated earnings and profits represented by the dividend, including current year earnings and profits. The 60-day rule would be repealed. Earnings and profits would be computed in the same manner for actual distributions and for subpart F inclusions, generally following the subpart F rules. However, the rules for translating foreign currency would be modified. *Effective date.*—Taxable years beginning after 1985. Future dividends would be treated as paid first out of accumulated profits of the payor derived after the effective date. Dividends in excess of that amount would be treated as paid out of pre-effective date accumulated profits under present-law ordering rules.	Same as President's proposal.
3. Source Rules			
1. Income derived from purchase and sale of inventory-type property	Generally sourced where title to the property passes. The title passage rule allows taxpayers to obtain foreign sourcing for sales income by passing title to the property sold offshore regardless of where the economic activity generating the income took place.	Eliminate the title passage rule. Generally source in the country of residence of the seller. If the seller has a fixed place of business outside the country of residence that participates materially in the sale, source where that fixed place of business is located. The fixed place of business exception would not apply in the case of sales to related foreign persons. *Effective date.*—Generally, taxable years beginning after 1985. Transitional rules would be provided for sales made under unrelated party contracts entered into before 1986.	Generally, same as President's Proposal, but provide anti-abuse rules to prevent manipulation of the basic residence-of-the-seller source rule. Clarify that, for purposes of the fixed place of business exception, no fixed place of business exists in a country with respect to income which that country is barred by treaty from taxing. *Effective date.*—Same as President's proposal.
2. Income from manufacture and sale of inventory-type property	Under Treasury regulations, half is treated as manufacturing income and sourced in the country of manufacture and half is treated as sales income and sourced under the title passage rule described in 1., above for income from the purchase and sale of inventory. The division of such income between manufacturing and sales may be made on the basis of an independent factory price instead if one exists.	Eliminate the title passage rule for the sales portion of such income and source that portion of the income under the proposed rules described in 1., above for income from the purchase and sale of inventory-type property.	For the sales portion of such income, same as the possible modifications described in 1., above to the President's proposed source rules for income from the purchase and sale of inventory-type property.

Item	Present Law	President's Proposal	Possible Option
2. Income from manufacture and sale of inventory-type property (Cont.)		Source the manufacturing portion of such income as under present law. Retain the 50/50 formula and independent factory price option for allocating such income between manufacturing and sales activity. *Effective date.*—Taxable years beginning after 1985. Transitional rules would be provided for sales made under unrelated party contracts entered into before 1986.	Require that *at least* 50 percent of such income be allocated to manufacturing activity under regulations. *Effective date.*—Same as President's proposal.
3. Income from intangible property	Royalties from licensing intangible property are sourced where the property is used. Generally, income from sales of intangible property is sourced under the title passage test described in 1., above. Some income from sales of intangible property for an amount contingent on the use of the property is sourced where the property is used.	Retain the place-of-use source rule for royalties from licensing intangibles. Modify the source rules for income from sales of intangibles to correspond to the place-of-use source rule for intangible royalties. *Effective date.*—Generally, taxable years beginning after 1985. Transitional rules would be provided for sales made under unrelated party contracts entered into before 1986.	Same as President's proposal. Source income from sales of intangibles (except sales for amounts contingent on the use of the intangibles) under rules similar to those proposed by the President for income from the purchase and sale of inventory-type property as the latter rules would be modified under the Possible Options described at 1., above. *Effective date.*—Same as President's proposal.
4. Income derived from sale of other personal property	Generally sourced under the title passage rule described at 1., above.	Income derived from sales of personal property used by the seller in his business would be sourced where the property was used. Income derived from sales of other personal property, including passive investment property such as securities and commodity futures contracts, would be sourced in the country of residence of the seller. *Effective date.*—Generally, taxable years beginning after 1985. Transitional rules would be provided for sales made under unrelated party contracts entered into before 1986.	Source recapture income derived from sales of personal property used by the seller in his business where deductions with respect to such property previously offset income, to the extent of such deductions. Source any sales income exceeding previous deductions under rules similar to those proposed by the President for income from the purchase and sale of inventory-type property as the latter rules would be modified under the Possible Options described at 1., above. Same as President's proposal. *Effective date.*—Same as President's proposal.

Item	Present Law	President's Proposal	Possible Option
. Transportation income	Treasury regulations generally allocate transportation services income between U.S. and foreign sources in proportion to the expenses incurred in providing the services. Expenses incurred outside the three-mile limit to the territorial waters of the United States are treated as foreign for this calculation. Income and losses from transportation that begins and ends in the United States are sourced in the United States. Income and losses from transportation that begins in the United States and ends in a U.S. possession (or vice versa) generally is treated as 50-percent U.S. source and 50-percent possessions source.	Reassess the rule allocating transportation income to U.S. and foreign sources in proportion to where expenses are incurred; possibly substitute for it a 50-percent rule similar to that for U.S.-U.S. possessions transportation income.	Source transportation income attributable to U.S.-foreign and foreign-U.S. routes as 50-percent U.S. source income and 50-percent foreign source income.
	Under a special rule, income and expenses associated with the lease or disposition of a vessel or aircraft that is constructed in the United States and leased to U.S. persons are sourced in the United States, regardless of where the vessel or aircraft may be used.	Repeal special rule.	Same as President's proposal.
	A similar rule applies to transportation income and expenses associated with the lease of an aircraft (wherever constructed) to a regularly scheduled U.S. air carrier, to the extent the aircraft is used on U.S.-U.S. possessions routes.	Retain present law.	Repeal.
	The United States does not tax foreign persons' earnings from the operation of ships and aircraft registered in foreign countries that grant equivalent exemptions to U.S. citizens and U.S. corporations.	Retain present law.	Modify the exemption for foreign persons' shipping and aircraft income so that its availability turns on whether a foreign person's *residence* country gives U.S. citizens and U.S. corporations an equivalent foreign tax exemption, not on whether the country where the ship or aircraft is registered gives such an exemption.
	The United States (in contrast with a number of countries) does not impose a gross-basis tax on domestic source shipping income of foreign persons.	Retain present law.	Impose a four-percent gross-basis tax on U.S. source shipping income of foreign persons.
		Effective date.—Generally, taxable years beginning after 1985. The repeal of the special U.S. sourcing rules for certain leasing income would not affect income attributable to an asset owned on January 1, 1986, if that asset was first leased before that date.	*Effective date.*—Generally, taxable years beginning after 1985. The repeal of the special U.S. sourcing rule for certain leasing (and transportation) income would not affect income attributable to an asset owned on January 1, 1986, if that asset was first leased before that date.

Item	Present Law	President's Proposal	Possible Option
6. Other offshore income and income earned in space	Generally, treated as foreign source income. Some taxpayers treat certain space-related income as U.S. source income.	None.	Source other offshore income and income earned in space in the recipient's country of residence. *Effective date.*—Taxable years beginning after 1985.
7. Dividend and interest income	Generally sourced in the residence country of the payor (in the case of a corporation, its country of incorporation). However, if a U.S. corporation earns more than 80 percent of its income from foreign sources (such a corporation is known as an "80/20 company", dividends and interest paid by the corporation are treated as foreign source income.	Repeal the exceptions to the general source rules for interest and dividends paid by 80/20 companies.	Treat interest and dividends paid by 80/20 companies as foreign source to the extent that the company's income is derived from foreign sources in the active conduct of a trade or business outside of the United States. For foreign tax credit purposes treat as U.S. source unless the income is connected with an active financing business of an unrelated U.S. payee conducted outside of the United States.
	Present law effectively exempts from U.S. tax some categories of interest income when earned by foreign persons (for example, interest earned on U.S. bank deposits) by treating the income as foreign source.	Retain the present law exemptions but restructure some of them (including that for U.S. bank deposits) as overt exemptions and treat the interest subject to the restructured exemptions as U.S. source. *Effective date.*—Generally, taxable years beginning after 1985. The modification of the source rule for interest paid by 80/20 companies would apply to interest paid on debt obligations incurred after January 1, 1986.	Same as President's proposal. *Effective date.*—Same as President's proposal.
8. Allocation of interest and other expenses	Under Treasury regulations, taxpayers generally allocate interest and other expenses between gross U.S. and gross foreign income on a separate, company-by-company basis, even if they are members of an affiliated group. The separate company allocation rule conflicts with a Court of Claims case, decided before the regulations became effective, which indicates that expenses that are not definitely allocable against U.S. or foreign gross income should be deducted from gross income on a consolidated group basis.	Corporations joining in filing a consolidated return (but not other corporate members of affiliated groups) would be required to allocate interest expense on a consolidated group basis rather than on a company-by-company basis.	Require all corporate members of affiliated groups to allocate all expenses (not interest only) on a consolidated group basis. Permit some corporations that cannot join in filing consolidated returns to continue allocating expenses on a separate company basis. Permit some financial and similar companies to continue allocating expenses on a separate company basis if their borrowing and lending activities are independent.
	Generally, under Treasury regulations, interest expense is allocated between U.S. and foreign income on the basis of the value of the taxpayer's assets that generate U.S. and foreign income.	None.	Modify the asset method of allocating interest expense so that appreciation of foreign assets is taken into account.
	Optional gross income methods for apportioning interest expense are also available under the regulations.	None.	Eliminate the optional gross income methods for apportioning interest expense.

Item	Present Law	President's Proposal	Possible Option
8. Allocation of interest and other expenses (cont.)	Taxpayers generally may take into account tax-exempt income and assets in allocating deductible interest and other expenses. Since tax-exempt income and assets are generally U.S.-based, taxpayers can derive a second tax benefit (higher foreign income and, hence, a higher foreign tax credit limitation) from ownership of tax-exempt assets.	Tax-exempt income and assets generating tax-exempt income would not be taken into account for purposes of allocating interest expense. *Effective date.*—Generally, taxable years beginning after 1985. Tax-exempt obligations held before 1986, and income derived from such obligations, could continue to be taken into account for purposes of allocating interest expense.	Tax-exempt income and assets generating tax-exempt income would not be taken into account for purposes of allocating expenses generally. *Effective date.*—Generally, same as President's Proposal. The allocation of interest on pre-existing loans on a consolidated group basis would be phased in over a three-year period.
U.S. Taxation Of Income Earned Through Foreign Corporations			
1. Tax haven income subject to current tax			
a. Tax haven income generally	In general, no current U.S. tax applies to the foreign income of a foreign corporation, and a U.S. investor in a foreign corporation is taxed only when income is distributed to him. However, the deferral of U.S. tax on the income of U.S.-owned foreign corporations does not apply to certain kinds of income that are suited to tax haven operations. Under the Code's subpart F rules, when a U.S.-controlled foreign corporation earns this tax-haven income, the United States will generally tax the corporation's 10-percent U.S. shareholders currently.		
	Subpart F income includes foreign personal holding company (FPHC) income, consisting generally of several types of passive income. Some passive income is not included in FPHC income, however.	None.	Add the following types of passive income to FPHC income for subpart F purposes: gain from the sale of any property that gives rise to passive income (not limited to stocks and bonds as under present law), income from commodities transactions generally (subject to a hedging exception), and foreign currency gains generally. Clarify that leasing income generally is FPHC income for subpart F purposes. In addition, repeal the exceptions for banking and insurance income and unrelated party rents and royalties. The exclusion from FPHC income of certain payments from related persons in the same foreign country would be limited by a look-through rule that takes into account the income of a related party payor.
	Subpart F income also includes foreign base company shipping income (which excludes shipping income reinvested in shipping operations).	None.	Repeal the exclusion from current taxation of reinvested shipping income.

Item	Present Law	President's Proposal	Possible Option
a. Tax haven income generally (Cont.)	Other categories of subpart F income include certain income from the insurance of U.S. risks and foreign base company income from certain sales and services (including insuring related persons' third-country risks). Foreign corporate earnings from insuring foreign risks of unrelated persons are not subject to current U.S. tax under subpart F.	None.	Amend the definition of tax haven income to include income from the insurance of unrelated persons' risks outside of the insuring company's country of incorporation; repeal the 5-percent de minimis exception for income from the insurance of U.S. risks.
	Current U.S. tax is generally not imposed under subpart F if the IRS finds that a U.S.-controlled foreign corporation was not formed or used to avoid tax.	None.	Replace the subjective tax-avoidance test with an objective test that looks to the rate of foreign tax paid by a U.S.-controlled foreign corporation, allowing the IRS to determine whether income (otherwise subject to subpart F) is properly treated as tax-haven income. *Effective date.*—Taxable years of foreign corporations beginning after 1985.
b. Determination of U.S. control of foreign corporation	The rules that impose U.S. tax currently on tax haven income of a foreign corporation apply only if a U.S. ownership requirement is satisfied: more than 50 percent of the voting power of the corporation must belong to U.S. persons each of which owns at least 10 percent of the voting power. Older, similar, but less extensive rules requiring current U.S. taxation—the foreign personal holding company (FPHC) rules—apply only if more than 50 percent of the value of the corporation belongs to five or fewer U.S. individuals.	None.	Amend the U.S. ownership requirements for imposition of the anti-tax haven and FPHC rules. For the anti-tax haven rules to apply, 50 percent or more (rather than more than 50 percent) of the vote or value (not merely vote) of a foreign corporation would have to belong to 10-percent U.S. shareholders. Similarly, for the FPHC rules to apply, 50 percent or more (rather than more than 50 percent) of the vote or value of a foreign corporation would have to be owned by five or fewer U.S. individuals. *Effective date.*—Generally, taxable years beginning after 1985. Provide appropriate transitional rules for existing investments.
c. De minimis tax haven income rule	The rules that impose current U.S. tax on foreign base company income (a type of tax haven income) of a foreign corporation apply only if certain threshold requirements are met. One such requirement is that 10 percent or more of the foreign corporation's gross income must be tax haven income. If more than 70 percent of the foreign corporation's gross income is base company income, all of its gross income is treated as base company income.	None.	The de minimis and 70-percent rules for foreign base company income would be applied on the basis of earnings and profits instead of gross income. *Effective date.*—Taxable years of foreign corporations beginning after 1985.

Item	Present Law	President's Proposal	Possible Option
d. Foreign investment companies	Generally, no current U.S. tax applies to the foreign income of a foreign corporation that is not a controlled foreign corporation (under subpart F) or a foreign personal holding company (under the FPHC rules) even if all its income is passive income or other tax haven income, and even if all its shareholders are Americans. When a U.S. person disposes of stock in a foreign investment company (FIC), however, the gain is not automatically subject to a favorable capital gains tax rate, even if the company is widely held. The gain is subject to ordinary income treatment to the extent of the shareholder's share of the FIC's earnings and profits. This special ordinary income rule generally applies to a foreign corporation that is primarily in the business of investing or trading in securities or commodities, if 50 percent or more of the corporation's stock (by vote or value) is held by U.S. persons.	None.	Amend the FIC rules as follows: (1) Require current recognition of gain or loss accrued by U.S. investors in FICs (by comparing year-end fair market value of the investment with its adjusted basis); and (2) Apply the FIC rules to U.S. investors in foreign funds without regard to the degree of U.S. ownership of such funds. *Effective date.*—Taxable years of U.S. investors beginning after 1985.
e. Possessions corporations	A corporation chartered in a U.S. possession with at least 80 percent of its income derived in the possessions and no more than 50 percent of its gross income from passive investments is not treated as a controlled foreign corporation; thus U.S. tax on its tax haven income is deferred.	This exception to the anti-tax haven rules would be repealed, subject to a transition rule. *Effective date.*—Taxable years beginning after 1985. Under a transition rule, earnings and profits accrued and property acquired in taxable years beginning before 1986 would be exempt from the application of the anti-tax haven rules that would otherwise result from the repeal of the exception for corporations chartered in the possessions.	Same as President's proposal. *Effective date.*—Same as President's proposal.
2. Application of accumulated earnings tax and personal holding company tax to foreign corporations	The accumulated earnings tax (AET) and personal holding company (PHC) tax are imposed on corporations that accumulate earnings rather than distributing them to their shareholders. The taxes are imposed on "accumulated taxable income" and "undistributed personal holding company income," respectively. Those amounts are calculated by making several adjustments to the regular taxable income of a corporation, including deductions for capital gains (and certain capital losses).	None.	For purposes of calculating the AET or PHC tax applicable to a foreign corporation, allow an adjustment for capital gains and lossess only if they are effectively connected with the conduct of a U.S. trade or business. *Effective date.*—Taxable years beginning after 1985.

Item	Present Law	President's Proposal	Possible Option
3. Election to be treated as U.S. corporation.	U.S. taxpayers that control business operations in foreign countries are taxed differently depending on whether they operate through a foreign corporation or directly through a foreign branch of a U.S. corporation. Those that operate abroad in branch form pay current U.S. tax on their branch earnings but are also able to reduce their U.S. taxable income from domestic operations by any overall foreign loss, unlike those operating through foreign corporations. In addition, a U.S. taxpayer's foreign corporate subsidiary cannot join in the filing of a consolidated return, and the creditability of foreign taxes paid by such a subsidiary is affected by the calculation of its earnings and profits. In some cases, U.S. taxpayers must operate in foreign corporate form due to foreign law restrictions or local business conditions.	None.	Permit certain U.S.-controlled foreign corporations to elect to be treated as domestic corporations for U.S. tax purposes. Rules generally similar to those of section 367 would be applied to prevent avoidance of tax on prior earnings and on post-election transfers or deemed transfers. *Effective date.*—Taxable years of foreign corporations beginning after 1985.

Item	Present Law	President's Proposal	Possible Option
). Special Tax Provisions for U.S. Persons			
1. Possession tax credit			
a. Income-based credit	U.S. corporations meeting certain requirements are allowed to claim an income tax credit for U.S. tax on U.S. possession source income. Similar rules apply to the U.S. Virgin Islands. To qualify, at least 80 percent of a possession subsidiary's income must be derived from the possessions, and no more than 35 percent of the income may be from passive investments. The possession tax credit is not allowed with respect to income generated from intangibles transferred to the possessions unless the taxpayer elects one of two optional methods of allocating intangible income: (1) the cost sharing method or (2) the 50/50 profit split method. The two intangible income allocation methods are not allowed for any product unless (1) at least 25 percent of the value added to the product is a result of economic activity in the possessions, or (2) at least 65 percent of the direct labor cost for the product is incurred in the possessions.	The possession tax credit would be repealed, subject to a 5-year transition rule, and replaced with a tax credit based on wages paid by manufacturing establishments in the possessions (and the U.S. Virgin Islands described at b., below). *Effective date.*—Under a transition rule, corporations could elect to continue to use the present tax credit for 5 years, beginning with the first taxable year ending after 1985, with respect to possession source income from products that were manufactured or validly designated during the taxable year beginning in 1985.	Retain present law except: (1) the credit on passive investment income would be limited to one-half of the U.S. tax on such income, and (2) the cost sharing method of allocating intangible income would be repealed. *Effective date.*—Taxable years beginning after 1985.
b. Wage credit	No provision.	The credit for wages paid by manufacturing establishments in the possessions would equal 60 percent of wages up to the Federal minimum wage (currently $6,968 on an annual basis), plus 20 percent of wages in excess of the minimum wage, up to four times the minimum wage ($24,872 per annum). The maximum credit would be 120 percent of the minimum wage ($8,361.60 per annum). Wages that are credited would not be deductible from gross income. The wage credit would not be refundable, but could be carried forward 15 years and used to reduce tax on income from outside the possessions.	Retain present law.

Item	Present Law	President's Proposal	Possible Option
b. Wage credit (cont.)		U.S. companies that elect the wage credit would be subject to the following rules: (1) possession taxes would not be eligible for the foreign tax credit, but instead would be deductible; (2) all income would be taxed currently; (3) dividends paid by possession corporations to U.S. affiliates would be treated as U.S. corporate dividends (eligible for the dividend-received deduction); and (4) property used in the possessions would be eligible for incentive depreciation (CCRS). *Effective date.*—The wage credit would be available for taxable years beginning after 1985.	
2. Other rules with respect to U.S. possessions *a. U.S. Virgin Islands*	The U.S. Virgin Islands (like Guam, the Commonwealth of the Northern Mariana Islands, and Samoa (see b., below)) generally uses the Code as it changes from time to time as its local tax code. For corporate tax purposes, the United States treats each of these possessions as a foreign country and each of these possessions treats the United States as a foreign country. This system of taxation has acquired the name "mirror system" because the possession uses the Code (but substitutes its own name for the United States and, for some purposes, treats the United States as the United States treats a possession). The Virgin Islands may impose a surtax of up to 10 percent on the mirror tax. The Virgin Islands can rebate its mirror tax on its resident individuals and on U.S. and V.I. corporations that operate primarily in the Virgin Islands.	In general, clarify the operation of the U.S. Virgin Islands' mirror system to prevent unintended results. Treat any bona fide V.I. resident on the last day of the taxable year as taxable only in the Virgin Islands, and not in the United States. A U.S. individual (other than a V.I. resident) who derives income from the Virgin Islands would file two identical returns, one with the United States and one with the Virgin Islands, and would pay a pro rata amount of tax to each. Provide for cooperation between the IRS and the Virgin Islands Bureau of Internal Revenue. Permit the Virgin Islands to impose any nondiscriminatory local income taxes in addition to those it now imposes under the mirror system. Permit the Virgin Islands to rebate tax on U.S. corporations whatever the extent of their activities in the Virgin Islands. Consider authorizing the Virgin Islands to reduce or rebate V.I. tax on some foreign persons' V.I. income.	Eliminate the mirror system for the Virgin Islands and adopt for the Virgin Islands the treatment proposed by the Administration for the other possessions, with the possible effective date option indicated. (See b., below.)

Item	Present Law	President's Proposal	Possible Option
a. U.S. Virgin Islands (cont.)	An "inhabitant" of the Virgin Islands pays tax to the Virgin Islands on its worldwide income, but pays no U.S. tax. Certain corporations qualify for inhabitant status, including some U.S. corporations.	Repeal the V.I. inhabitant rule.	Same as President's proposal.
	A V.I. corporation is not subject to the U.S. 30-percent withholding tax on passive income so long as it meets criteria designed to prevent the use of V.I. corporations as conduits for third-country residents: the V.I. corporation must be less than 25 percent foreign-owned and earn at least 20 percent of its income from V.I. sources.	Amend the rules that prevent foreigners from using V.I. corporations as conduits to avoid the U.S. 30-percent withholding tax by substituting a requirement that 65 percent of a corporation's income be effectively connected with a trade or business in a possession or in the United States, in place of the 20-percent source of income requirement in current law.	Same as President's proposal.
		Effective date.—Taxable years beginning after 1985.	*Effective date.*—Same as President's proposal.
b. Guam, the Northern Mariana Islands, and American Samoa	U.S. law requires that Guam use the Code as its local tax code. (See general description of the mirror system of taxation at a., above.) Individual residents of the United States or Guam need file a tax return only with the place where they resided on the last day of the year. Guamanian corporations are not subject to the U.S. 30-percent withholding tax, except Guamanian corporations that foreign persons may use as conduits (under the rules that apply to V.I. corporations). The Commonwealth of the Northern Mariana Islands (CNMI) is required to use the mirror system in basically the same way as Guam. The latter treatment generally began on January 1, 1985.	Grant Guam and the CNMI full authority to determine their own income tax laws. This treatment would place them on a par with American Samoa. Require that Guam and the CNMI implement tax systems that would raise at least as much revenue as their current mirror systems. Residents of Guam and the CNMI who received income from outside those possessions would have to file U.S. tax returns. The United States would collect the tax on that non-possession income, but would transfer the money to the possession where the taxpayer resided. For the purpose of the U.S. 30-percent withholding tax, the proposal would modify the anti-conduit rule for Guam and the CNMI in the same way as proposed for the Virgin Islands.	Same as President's proposal, except for effective date modification indicated below.

Item	Present Law	President's Proposal	Possible Option
b. Guam, the Northern Mariana Islands, and American Samoa (cont.)	American Samoa has adopted its own income tax system. American Samoa has chosen to use the Code, with minor amendments, as its internal income tax system.	For American Samoa (as well as for Guam and the CNMI), implement anti-abuse provisions to prevent the use of corporations in these possessions to avoid U.S. tax. Coordinate taxes among these possessions and exchange information between each possession and the United States. Each possession would receive taxes withheld on compensation of U.S. Government personnel stationed there. *Effective date.*—Generally, January 1, 1986. The mirror codes of Guam and the CNMI would continue to operate until and except to the extent that each possession took action to amend its own laws.	Same as President's proposal. *Effective date.*—Same as President's proposal, but any continued operation of mirror codes in Guam and the CNMI would be with respect to the Code as in effect prior to the general effective date of the tax reform legislation.
3. Taxation of U.S. employees of Panama Canal Commission	An agreement between the United States and Panama entered into in conjunction with the Panama Canal Treaty specifies the rights and legal status of agencies and employees of the U.S. Government operating in Panama. One article of the agreement provides an exemption from tax for U.S. employees of the Panama Canal Commission. In a diplomatic note, Panama has confirmed the United States' explanation that the exemption was intended to apply solely to Panamanian taxes. However, one appeals court, excluding the U.S. explanation and diplomatic note from evidence, held that the plain language of the treaty requires an exemption from U.S. tax for the salaries of U.S. employees of the Commission. Another appeals court has held, based on the U.S. explanation and diplomatic note, that the exemption is limited to Panamanian taxes.	None.	Clarify that the Agreement in Implementation of Article III of the Panama Canal Treaty does not exempt U.S. taxpayers from U.S. tax.

Item	Present Law	President's Proposal	Possible Option
4. Foreign Sales Corporations (FSCs)	The United States limits its tax on qualified income from exports when the exporter uses a "FSC"—a Foreign Sales Corporation. The FSC rules reduce taxable income by 16 percent of export income (15 percent for corporate shareholders). The Domestic International Sales Corporation (DISC) rules provide a similar benefit but only on the income from $10 million in export sales.	None.	Change FSC rules to exempt 14 percent of export income (13 percent for corporate shareholders). Make corresponding changes to DISC rules. *Effective date.*—Generally, taxable years beginning after 1985.
5. Private sector earnings of Americans abroad	U.S. citizens (other than U.S. Government employees) who live and work abroad and who satisfy certain physical presence or bona fide foreign residence tests may exclude from gross income their foreign earned income, up to $80,000 per year, and may also exclude their foreign housing costs that exceed a base amount. The $80,000 ceiling on excludable foreign earned income is scheduled to increase $5,000 each year beginning in 1988, up to $95,000 for taxable years beginning in or after 1990. This schedule reflects a Deficit Reduction Act of 1984 freeze of the increases, which the Economic Recovery Tax Act of 1981 had scheduled to begin in 1984.	None.	Reduce the foreign earned income exclusion ceiling to $50,000. *Effective date.*—Taxable years beginning after 1985.

Item	Present Law	President's Proposal	Possible Option
Foreign Taxpayers 1. **Branch-level tax**	Foreign corporations are subject to U.S. corporate-level tax on income effectively connected with a U.S. trade or business. A shareholder-level tax also is imposed on some foreign corporate earnings: a 30-percent gross withholding tax applies to a pro rata portion of dividends paid by a foreign corporation if more than 50 percent of the corporation's income over a three-year period is effectively connected with a U.S. trade or business. A similar withholding tax applies to interest payments by foreign corporations. The withholding taxes are reduced or eliminated under a number of U.S. tax treaties. Some countries substitute a branch-level tax for a direct shareholder-level tax on domestic source earnings of foreign corporations.	Repeal the withholding taxes on dividends and interest paid by foreign corporations. Replace the dividend tax with a tax on remitted profits of U.S. branches of foreign corporations. Replace the interest tax with a tax on foreign corporations' interest payments that are allocable to U.S. branch operations. In both cases, tax would be imposed at a 30-percent rate, or at any lower treaty rate that would apply to direct-investment dividends paid to the foreign corporation. Tax would not be imposed when existing U.S. treaties prohibit a tax on branch profits—some argue that a number of existing treaties do so. *Effective date.*—Taxable years beginning after December 31, 1985.	Retain current law, with a reduction of the 50-percent limitation on the withholding taxes imposed on foreign corporations. *Effective date.*—The rule would apply to dividends paid out of earnings and profits earned in taxable years after 1985, and to interest paid in taxable years after 1985.
2. **Retain character of effectively connected income**	The United States taxes foreign persons' income that is effectively connected with a U.S. trade or business on a net basis at graduated rates, in the same manner that it taxes the income of U.S. persons. Foreign persons may not be subject to U.S. tax if they receive income that was earned by a U.S. trade or business in a year after the trade or business has ceased to exist (e.g., by selling property and recognizing the gain on the installment basis).	None.	Provide that income or gain will be treated as effectively connected with a U.S. trade or business if it is attributable to another taxable year and would have been so treated if it had been taken into account in that other year. *Effective date.*—Generally, taxable years after 1985.
3. **Tax-free exchanges by expatriates**	A U.S. citizen who gives up citizenship for a principal purpose of avoiding U.S. tax will generally continue for a period of ten years to be taxed as a citizen on U.S. source income, but not foreign source income. U.S. source income for this purpose includes gains from sales of U.S. property. Tax-avoidance expatriates may be able to avoid tax by making a tax-free exchange of U.S. property for foreign property.	None.	Apply the tax-avoidance expatriate rules to gains on the sale of property the basis of which was determined by reference to property located in the United States, stock of a U.S. corporation, or a debt obligation of any U.S. person. *Effective date.*—The rule would apply to sales of property acquired in tax-free exchanges after September 25, 1985.

Item	Present Law	President's Proposal	Possible Option
4. **Excise tax on insurance premiums paid to foreign insurers**	The United States imposes excise taxes on premiums paid for the direct insurance or reinsurance of U.S. risks to foreign entities not doing business in the United States. The rates are (per dollar of premium): four cents for casualty contracts, one cent for life contracts, and one cent for all reinsurance. The taxes are collected by return and liability falls jointly on all parties to the insurance transaction. Payments to some insurers are exempt by treaty, but reinsurance premiums paid by treaty-protected insurers are subject to the tax (unless the recipient is exempt by treaty). The present "two-tax system"—one tax on the direct insurance of a U.S. risk with a foreign insurer, and another, which generally is in addition to the first, on the reinsurance of a U.S. risk—is sometimes difficult to administer. Also, taxpayers may be able to structure insurance coverage for U.S. casualty risks so that only the lower tax on reinsurance premiums applies.	None.	Make the excise tax on casualty reinsurance premiums paid to foreign insurers for U.S. risk coverage equal to that on similar casualty insurance premiums (four percent). Impose an excise tax only once—on retained premiums received by foreign insurers or reinsurers. Make the foreign insurer (or his agent) liable for the tax and require the U.S. insured or broker obligated to transmit the premiums to withhold the tax. *Effective date.*—The tax would apply to premiums paid after December 31, 1985.

Item	Present Law	President's Proposal	Possible Option
Foreign Currency Exchange Gain Or Loss			
1. Foreign currency transactions			
a. Functional currency concept	For financial reporting purposes, the "functional currency" of a business entity—the currency of the economic environment in which it operates—is used as the reference point in determining exchange gains and losses. The functional currency concept is not embodied in present law.	Similar to the financial accounting rules, the determination of whether exchange gains or losses must be recognized on a transaction-by-transaction basis, or in the aggregate on an annual basis, would be determined on the basis of a business entity's functional currency.	Same as President's proposal.
b. Recognition of gain or loss on financial assets and liabilities	In many instances, present law is unclear regarding the timing of recognition of exchange gains or losses derived from foreign currency denominated financial assets or liabilities.	For financial assets or liabilities denominated in a currency other than an entity's functional currency, exchange gain or loss would arise if the exchange rate fluctuates between the date the item is taken into account for tax purposes and the date it is paid.	Same as President's proposal.
c. Current accrual of anticipated exchange gain or loss	No provision.	For a financial asset or liability that provides for fixed or determinable payments, "anticipated" exchange gain or loss would be accrued currently, under rules similar to the present-law rules that test the adequacy of interest on installment obligations by reference to the yield on U.S. Government securities.	Exchange gain or loss would be currently accrued only in the case of "hedging transactions" or, as provided in regulations, as necessary to clearly reflect income.
d. Character	No provision.	All exchange gain or loss would be treated as an increase or decrease in interest income or expense.	Exchange gain or loss would be treated as ordinary income or loss for collateral tax purposes.
e. Hedging transactions	No provision.	Exchange gain or loss on a contract that offsets the risk of exchange rate fluctuations with respect to a financial asset or liability would be recognized on an accrual basis, and characterized and sourced consistent with the treatment of the hedged item.	The scope of the hedging rule for exchange gain or loss and the hedging exemption under the tax straddle rules would be conformed, without a special rule for banks for either purpose.
2. Foreign currency translation			
a. Translation method	The Code does not prescribe rules for determining when and how the results of foreign operations involving transactions in foreign currencies are to be reported for U.S. tax purposes. The taxpayer may choose among several recognized methods of translating results of foreign operations, which methods may produce substantially different U.S. tax consequences.	A business entity that uses a functional currency other than the U.S. dollar would be required to use a profit-and-loss translation method. Generally, a single set of rules would be provided for branches and subsidiary corporations.	Same as President's proposal.

Item	Present Law	President's Proposal	Possible Option
b. Branch remittances and losses	When a foreign branch remits currency in excess of the current year's profit, the basis of the excess amount must be determined in order to calculate exchange gain or loss. Present law is unclear regarding the allocation of remittances between previously-taxed earnings and contributions to branch capital, and whether capital is fully recovered before any exchange gain or loss is recognized.	Exchange gain or loss on remittances in excess of current profits would be recognized in a manner that is analogous to the treatment of cash distributions from a partnership. A taxpayer's dollar basis in a foreign branch would be recovered before exchange gains or losses on remittances would be recognized.	Remittances by a branch in excess of current earnings generally would be assumed to consist first of prior years' earnings and then of capital contributions, on a last-in, first-out basis. Rules would be provided to preclude a deduction for branch losses in excess of a taxpayer's U.S. dollar investment in the foreign branch.
c. Direct foreign tax credits	For foreign taxes paid on income derived directly (e.g., through a branch), taxpayers generally translate the taxes at the exchange rate on the date paid. Adjustments to a foreign tax are translated at the exchange rate in effect on the date of adjustment.	A redetermined foreign tax would be translated at the exchange rate in effect on the payment date.	Same as President's proposal.
d. Indirect foreign tax credits	A tax credit is allowed to U.S. corporations for foreign taxes deemed paid with respect to dividends received from a foreign subsidiary, and with respect to deemed distributions of Subpart F income. The amount of the indirect credit is determined under a formula that takes into account the foreign taxes paid by the subsidiary, the amount of the dividend, and the subsidiary's earnings and profits ("E&P"). For this purpose, foreign taxes and the amount of the dividend are generally translated at the exchange rate on the date of receipt, under case law. Foreign taxes deemed paid with respect to Subpart F income are translated at an average rate for the period in which the income was earned by the foreign subsidiary. In the case of an actual distribution, E&P are translated at the exchange rate in effect on the date of distribution. In the case of a Subpart F dividend, E&P are translated at an average exchange rate for the year, adjusted to reflect unrealized exchange rate gains and losses.	The indirect foreign tax credit would be computed by using a common exchange rate (the rate on the date of distribution, or the average exchange rate for the year in the case of a deemed distribution) for the distribution or deemed distribution, earnings and profits, and foreign taxes.	Foreign taxes would be translated at the rate in effect on the date actually paid or accrued by the subsidiary rather than the current rate. Exchange gain or loss with respect to the earnings distributed (based on the historic rate for the year earned) would be treated as separate basket foreign-source income. *Effective date.*—Taxable years beginning after 1985.

VII. TAX-EXEMPT BONDS

Item	Present Law	President's Proposal	Possible Option
1. General Restrictions on Tax-Exemption	Interest on bonds issued by or on behalf of State and local governments the proceeds of which are to be used to finance government operations is tax-exempt.	Interest on bonds issued by or on behalf of State and local governments the proceeds of which are used to finance government operations would continue to be tax-exempt.	Interest on bonds issued by or on behalf of State and local governments the proceeds of which are to be used to finance government operations would continue to be tax-exempt. Under the option (as under present law), State and local governments could issue tax-exempt bonds to finance activities such as schools, highways, government buildings, governmental sewage and solid waste disposal systems, and governmental water and electric facilities, as well as operating expenses of the governments themselves.
	Interest on State and local government bonds is taxable if— (1) The bonds are *IDBs*— (a) More than 25 percent of the bond proceeds is to be used in a trade or business of a person other than a State or local government, or section 501(c)(3) organization, and (b) Repayment of the bonds is secured by or derived from income from property to be used in such a trade or business; or (2) The bonds are *private loan bonds*— (a) 5% or more of the bond proceeds is to be used to finance (directly or indirectly) loans to persons other than State or local governments or section 501(c)(3) organizations; and (b) The bonds are not— (i) IDBs, mortgage subsidy bonds, or student loan bonds for which tax-exemption specifically is provided in the Code, or (ii) Tax Assessment Bonds (bonds used to make loans (other than for use in a trade or business) to finance governmental taxes or assessments of a general nature and for an essential governmental function).	Interest on State and local government bonds would be taxable if more than 1 percent of the bond proceeds were used by any person other than a State or local governmental unit.	The 1 percent rule of the President's proposal would be liberalized to permit an amount of governmental bond proceeds equal to the lesser of 5 percent of proceeds or $5 million to be used by persons other than a State or local government. The new rule would be correlated with present-law concepts for IDBs and private loan bonds. Tax Assessment Bonds, defined as under present law (except expanded to permit loans to persons engaged in a trade or business), would be treated as governmental (i.e. tax-exempt) bonds.

Item	Present Law	President's Proposal	Possible Option
ι. General Restrictions on Tax-Exemption—Cont.	Exceptions are provided permitting tax-exemption for interest on bonds to finance certain specified private activities, discussed below.	No exceptions would be provided for bonds to finance specified activities or for bonds used by section 501(c)(3) organizations. Instead, interest on nongovernmental bonds would be tax-exempt only where the nongovernmental use occurred solely because— (i) Bond-financed property was leased to a person other than a State or local government for an initial period not exceeding 1 year after its completion; or (ii) Bond-financed property was operated by a person other than a State or local government pursuant to a management contract the term of which did not exceed 1 year.	Exceptions from the governmental use requirement would be provided as under present law for certain nongovernmental activities, discussed in B., below, including certain activities of section 501(c)(3) organizations.
	Use of bond-financed property is treated as use of bond proceeds. Use of bond-financed property or services by the general public is not treated as a private use if the property or services are available to all members of the general public on the same basis. Management contracts, output contracts, take-or-pay contracts, and leases, as well as actual ownership of property, are examples of situations where all members of the general public do not use property or services on the same basis.	The President's proposal would treat use of bond-financed property or services on the same basis by all members of the general public as nongovernmental (i.e., taxable) use, but would treat such use as an exception to its governmental use rule.	Same as present law.
			Effective date.—Bonds issued after December 31, 1985. *Exceptions.*—(1) Obligations with respect to facilities— (a) The original use of which commences with the taxpayer and the construction, reconstruction, or rehabilitation of which began before September 26, 1985, and was completed on or after that date, or (b) With respect to which a binding contract to incur significant expenditures was entered into before September 26, 1985, and part or all of such expenditures were incurred on or after that date. Significant expenditures would be defined as expenditures in excess of 10% of the estimated cost of the facility. Facilities eligible for the exception would be defined as property for which bond financing was approved by a governmental unit (or by voter referendum) before September 26, 1985.

Item	Present Law	President's Proposal	Possible Option
. General Restrictions on Tax-Exemption—Cont.			(2) Refundings of bonds (a) that were issued before January 1, 1986 (including a series of refundings); (b) that are governmental bonds under present law; and (c) that could not be originally issued under the option, if— (i) The amount of the refunding bonds did not exceed the outstanding amount of the refunded bonds; and (ii) The refunding bonds (or series of refundings) did not have a maturity date later than the date which is the later of (a) 120% of the economic life of the property identified as being financed with the original (refunded) bonds when issued, or (b) 15 years after issuance of the original bonds. This rule would not change the present-law restriction on refunding private loan bonds issued before July 18, 1984.

Item	Present Law	President's Proposal	Possible Option
Tax-Exempt Bonds for Certain Nongovernmental Activities			
1. Industrial development bonds			
a. Exempt-activity IDBs	Exempt-activity IDBs are bonds the proceeds of which are to be used to finance—	The President's proposal includes no exceptions to the governmental use requirement based on the activity being financed.	Present law would be modified to permit interest on limited amounts of nongovernmental bonds to continue to be tax-exempt if bond proceeds were used to finance the following exempt facilities—
	(i) *Multifamily rental housing*—	(i) No tax exemption;	(i) *Multifamily rental housing*—
	(A) At least 20 percent (15 percent in targeted areas) of the housing units must be occupied by persons whose income does not exceed 80 percent of the area median income when they first rent the unit; and		(A) At least 30 percent (25 percent in targeted areas) of the housing units would be required to be occupied by persons whose income does not exceed 70 percent of the area median income, with at least 10 percent of all units being occupied by persons whose income does not exceed 50 percent of the area median income, determined on a continuing basis;
	(B) Must be used for rental housing for a "qualified project period," generally 10 years or 50 percent of the term of the bonds with the longest maturity;		(B) Must be used for rental housing for a "qualified project period," generally the longer of 15 years or the maturity date of the bonds with the longest term; and
			(C) Operator of project must certify to Treasury annually that project currently is in compliance with Code requirements.
			If noncompliance with (A), above, is not corrected within 6 months after it reasonably should have been discovered, interest on bond financing would be nondeductible to project owner from first day of year in which noncompliance commenced until correction occurred.
	Treasury regulations will require that the determination in (A), above, be made with adjustments for family size, for bonds issued after 1985.		Clarification would be made that the determinations in (A), above, are made with adjustments for family size.
	(ii) *Sports facilities;*	(ii) No tax exemption;	(ii) Same as President's proposal;
	(iii) *Convention or trade show facilities;*	(iii) No tax exemption;	(iii) Same as President's proposal;
	(iv) *Airports,* defined to include runways, terminals, and other public facilities, as well as airport hotels, hangars for one or more airlines, and other property not available for use by the general public, and related storage and training facilities;	(iv) No tax exemption;	(iv) *Airports* defined as ground facilities directly related to the transportation by air of passengers and their luggage (includes runways, air traffic control towers, terminal facilities, public parking, and airline hangers, but not airport hotels, food preparation facilities, and freight handling facilities);

Item	Present Law	President's Proposal	Possible Option
a. Exempt-activity IDBs—Cont.	(v) *Docks and wharves* and related storage and training facilities;	(v) No tax exemption;	(v) *Dock and wharf facilities* directly related to the transportation of passengers and cargo by water (excludes storage warehouses used other than in immediate transportation of goods);
	(vi) *Mass commuting facilities* and related storage and training facilities;	(vi) No tax exemption;	(vi) Same as President's proposal;
	(vii) *Parking facilities;*	(vii) No tax exemption;	(vii) Same as President's proposal;
	(viii) *Sewage disposal facilities;*	(viii) No tax exemption;	(viii) *Sewage disposal facilities* (defined as under present law except for modifications discussed below);
	(ix) *Solid waste disposal facilities;*	(ix) No tax exemption;	(ix) *Solid waste disposal facilities* (defined as under present law except for modifications discussed below);
	(x) *Electric energy and gas furnishing facilities* serving areas not exceeding 2 contiguous counties or a city and one contiguous county;	(x) No tax exemption;	(x) Same as President's proposal;
	(xi) *Certain facilities for the furnishing of water* (including irrigation systems);	(xi) No tax exemption;	(xi) *Certain facilities for the furnishing of water* (other than irrigation systems); In the case of sewage and solid waste disposal facilities and facilities for the furnishing of water, tax-exempt financing would be permitted only for those facilities that were either— (i) Operated by a governmental unit; or (ii) For which the rates were governmentally established. In addition, if 5 percent or more of any such facility were used by any one person who was not a governmental unit, tax-exempt financing would not be permitted for the portion of the facility so used that was in excess of 5 percent.
	(xii) *Certain hydroelectric generating facilities* (expires generally after December 31, 1985);	(xii) No tax exemption;	(xii) Same as President's proposal;
	(xiii) *Local district heating or cooling facilities;* and	(xiii) No tax exemption; and	(xiii) Same as President's proposal; and
	(xiv) *Air or water pollution control facilities.*	(xiv) No tax exemption.	(xiv) Same as President's proposal.

Item	Present Law	President's Proposal	Possible Option
a. Exempt-activity IDBs—Cont.			*Effective date.*—Bonds issued after December 31, 1985. *Exceptions.*—(1) Obligations with respect to facilities— (a) The original use of which commences with the taxpayer and the construction, reconstruction, or rehabilitation of which began before September 26, 1985, and was completed on or after that date, or (b) With respect to which a binding contract to incur significant expenditures was entered into before September 26, 1985, and part or all of such expenditures were incurred on or after that date. Significant expenditures would be defined as expenditures in excess of 10% of the estimated cost of the facility. Facilities eligible for the exception would be defined as property for which bond financing was approved by a governmental unit (or by voter referendum) before September 26, 1985. (2) Refunding of IDBs (1) that were issued before January 1, 1986 (including a series of refundings), (2) that may be issued under present law, and (3) that could not be originally issued under the option, if— (a) The amount of the refunding bonds did not exceed the outstanding amount of the refunded bonds; (b) The refunding bonds (or series of refundings) did not have a maturity date later than the date which is the later of (a) 120% of the economic life of the property financed with the original (refunded) bonds, or (b) 15 years after issuance of the original bonds.
b. Extension of miscellaneous restrictions to all exempt facility bonds i. Use of bond proceeds for activity qualifying for tax-exempt financing	Only 90 percent of IDB proceeds are required to be used for purpose of bond issue; the remaining 10 percent may be used for any purpose. In the case of exempt-activity IDBs, all property that is "functionally related and subordinate to" the exempt activity may be financed with bond proceeds and counts towards satisfaction of the 90 percent requirement.	No tax exemption for nongovernmental bonds.	All proceeds of nongovernmental bonds for exempt facilities (other than costs of issuance and proceeds invested in a reasonably required debt service reserve fund) would be required to be used for the activity qualifying the interest on the bonds for tax-exemption. Bonds in excess of the volume actually used for the activity qualifying for tax-exempt financing would be required to be retired within 30 days after acquisition of bond-financed property or 30 days after construction was more than 90 percent completed.

Item	Present Law	President's Proposal	Possible Option
			Effective date.—Bonds issued after December 31, 1985.
ii. Ownership of property financed with nongovernmental bonds for exempt facilities	Property financed with private activity bond proceeds may be owned by persons other than State or local governmental units.	No tax exemption for nongovernmental bonds.	Generally, all property financed with nongovernmental exempt facility bonds would be required to be owned by a State or local governmental unit. The determination of ownership would be made using general Federal income tax rules for determining the tax owner of property. An exception would be provided for qualified multifamily rental housing facilities financed with exempt facility bonds. *Effective date.*—Bonds issued after December 31, 1985. Transitional exceptions like those provided for exempt facility bonds (item B.1.a., above).
c. Industrial park IDBs	Interest is tax-exempt on IDBs to be used to finance acquisition or development of land as a site for an industrial park.	No tax exemption for nongovernmental bonds.	Same as President's proposal. *Effective date.*—Bonds issued after December 31, 1985. Transitional exceptions like those provided for exempt facility bonds (item B.1.a., above).
d. Small-issue IDBs	Interest on small-issue IDBs is tax-exempt. Small-issue IDBs are issues not exceeding $1 million, the proceeds of which generally may be used to finance land or any depreciable property. The $1 million size limitation is increased to $10 million if an election is made to take certain capital expenditures into account. This exception expires generally after December 31, 1986 (December 31, 1988, in the case of bonds to finance manufacturing facilities).	No tax exemption for nongovernmental bonds.	Same as President's Proposal. *Effective date.*—Bonds issued after December 31, 1985. *Exception.*—Refundings of bonds issued before January 1, 1986, if— (i) The maturity date of the refunding bonds is not later than the maturity date of the refunded bonds; (ii) The interest rate on the refunding bonds is lower than the rate on the refunded bonds; and (iii) The amount of the refunding bonds does not exceed the outstanding amount of the refunded bonds.

Item	Present Law	President's Proposal	Possible Option
2. Student loan bonds	Tax-exemption is permitted for interest on student loan bonds issued in connection with the Department of Education's Guaranteed Student Loan program.	No tax exemption for nongovernmental bonds.	Same as President's proposal. *Effective date.*—Bonds issued after December 31, 1985. *Exception.*—Refundings (or series of refundings) of bonds issued before January 1, 1986, if the maturity date of the refunding bonds does not exceed the later of— (i) The maturity of the refunded bonds; or (ii) The date that is 15 years after the date the refunded bond was issued (or in the case of a series of refundings, the date the original bond was issued), and the amount of the refunding bonds does not exceed the outstanding amount of refunded bonds.
3. Mortgage subsidy bonds			
a. Qualified mortgage bonds and mortgage credit certificates	Qualified mortgage bonds must be used to finance mortgages on single-family, owner-occupied residences. The targeting requirements to these bonds include the following: (i) At least 90 percent of the lendable proceeds of each issue must be used to finance loans to first-time homebuyers; (ii) The purchase price of bond-financed residences may not exceed 110 percent (120 percent in targeted areas) of the average area purchase price applicable to that residence; and (iii) Issuers must publish and submit to the Treasury annual reports of their policies on the use of bond proceeds.	No tax exemption for nongovernmental bonds.	Interest on qualified mortgage bonds would continue to be tax-exempt. The present-law targeting requirements would be modified as follows: (i) All bond proceeds (other than issuance costs and amounts invested in reasonably required reserve funds) would be required to be used to finance residences for first-time homebuyers; (ii) The purchase price of bond-financed residences could not exceed 90 percent (110 percent in targeted areas) of the average area purchase price applicable to that residence; (iii) Delete present-law requirement of annual Treasury reports; and

Item	Present Law	President's Proposal	Possible Option
a. Qualified mortgage bonds—and mortgage credit certificates (cont'd.)			(iv) At least 50 percent of the mortgage loans made would be required to be made to borrowers whose family income did not exceed 90 percent of area median income, and all such loans would be required to be made to borrowers whose income did not exceed 115 percent of area median income. In targeted areas, ⅓ of the loans could be made to borrowers without regard to the above income limits; the balance of the loans would have to be made to mortgagors having incomes not exceeding 140 percent of the greater of— (A) The median income for the statistical area in which the residence was located, or (B) The Statewide median income for the State in which the residence was located.
	Issuers of qualified mortgage bonds may elect to exchange part or all of their bond authority for authority to issue Mortgage Credit Certificates (MCCs). MCCs generally are subject to the same targeting requirements as qualified mortgage bonds.	The MCC option would be repealed along with authority to issue qualified mortgage bonds.	Authority to issue MCCs would be continued. The targeting requirements for MCCs would be conformed to the revised targeting rules for qualified mortgage bonds.
	Authority to issue both qualified mortgage bonds and MCCs terminates after December 31, 1987.		Same as present law. *Effective date.*—Bonds issued and MCCs issued with respect to bond authority exchanged after December 31, 1985. (Would not apply to mortgage loans made with the proceeds of bonds issued before January 1, 1986.)

Item	Present Law	President's Proposal	Possible Option
b. Qualified veterans' mortgage bonds	Qualified veterans' mortgage bonds are bonds 90% or more of the proceeds of which are used to finance loans to veterans for the purchase of single-family, owner-occupied residences. Tax-exempt qualified veterans' mortgage bonds may be issued only by the five States that issued such bonds before June 22, 1984. Mortgage loans financed with those bonds may be made only to veterans who served on active duty before 1977 and who apply for a loan before 30 years after leaving active service.	No tax exemption for nongovernmental bonds.	Same as present law, except consistent with rules for other nongovernmental bonds, all bond proceeds (other than issuance costs and reasonably required reserve funds) would be required to be used for mortgage loans to qualified veterans. *Effective date.*—Bonds issued after December 31, 1985.
4. Tax-exempt bonds for section 501(c)(3) organizations	Interest on bonds for nonprofit organizations described in Code section 501(c)(3) generally is tax-exempt. Bonds the proceeds of which are to be used by these organizations are subject to the same requirements as bonds for general government operations. Examples of organizations benefiting from these bonds are private, nonprofit hospitals and private, nonprofit colleges and universities.	No tax exemption for nongovernmental bonds.	Tax-exempt bonds for section 501(c)(3) organizations would be permitted, as follows: (i) Only activities directly related to the exempt purpose of the organization could be financed (For example, a hospital could not finance a doctor's office building.), and all bond proceeds (other than costs of issuance and proceeds invested in a reasonably required debt service reserve fund) would be required to be used for such activities; (ii) In the case of section 501(c)(3) organizations other than hospitals, the aggregate amount of outstanding bonds of which each organization was a beneficiary could not exceed $40 million. (Generally, rules of the present $40 million limitation on beneficiaries of IDB-financing would be applied under this provision); and, (iii) All property financed with proceeds of these bonds would have to be owned by the section 501(c)(3) organization (using Federal income tax concepts of ownership). *Effective date.*—Bonds issued after December 31, 1985. *Exceptions.*—(1) Obligations with respect to facilities— (a) The original use of which commences with the taxpayer and the construction, reconstruction, or rehabilitation of which began before September 26, 1985, and was completed on or after that date, or

Item	Present Law	President's Proposal	Possible Option
4. Tax-exempt bonds for section 50(c)(3) organizations—Cont.			(b) With respect to which a binding contract to incur significant expenditures was entered into before September 26, 1985, and part or all of such expenditures were incurred on or after that date. Significant expenditures would be defined as expenditures in excess of 10% of the estimated cost of the facility. Facilities eligible for the exception would be defined as property for which bond financing was approved by a governmental unit (or by voter referendum) before September 26, 1985. (2) Refundings (including series of refundings) of section 501(c)(3) organization bonds (1) that were issued before January 1, 1986, (2) that may be issued under present law, and (3) that could not be originally issued under the option, if— (a) The amount of the refunding bonds did not exceed the outstanding amount of the refunded bonds; and (b) The refunding bonds (or series of refundings) did not have a maturity date later than the date which is the later of (i) 120% of the economic life of the property financed with the original (refunded) bonds, or (ii) 15 years after issuance of the original bonds.

Item	Present Law	President's Proposal	Possible Option
5. Miscellaneous restrictions on nongovernmental bonds			
a. Restriction on maturity of nongovernmental bonds	The weighted average maturity of IDBs may not exceed 120 percent of the economic life of the bond-financed property.	No tax exemption for nongovernmental bonds.	Extend present-law restriction to all nongovernmental bonds (other than mortgage subsidy bonds). *Effective date.*—Bonds issued after December 31, 1985.
b. Acquisition of land and existing property	Interest on IDBs generally is taxable if more than 25 percent of the proceeds of an issue is used for land. Acquisition of existing property may not be financed with tax-exempt IDBs unless a rehabilitation requirement is satisfied.	No tax exemption for nongovernmental bonds.	Extend present-law restrictions on tax-exempt financing of land and existing property to all nongovernmental bonds (other than mortgage subsidy bonds). *Effective date.*—Bonds issued after December 31, 1985. Transitional exceptions (for bonds not presently subject to these limitations) similar to those provided for section 501(c)(3) organization bonds in item B.4., above.
c. Public approval requirement	IDBs may be issued only after the issuer holds a public hearing and the bonds are approved by an elected local official. Alternatively, issuance of the bonds may be approved by a voter referendum.	No tax exemption for nongovernmental bonds.	Extend present IDB requirements to all nongovernmental bonds. *Effective date.*—Bonds issued after December 31, 1985.
d. Change in use of nongovernmental bond-financed property	Tax-exempt bonds generally are not required to be redeemed if the use of bond-financed property changes from a use qualifying interest on the bonds for tax-exemption to a nonqualified use.	No tax exemption for nongovernmental bonds.	A change in the use of bond-financed property to a use not qualifying for tax-exempt financing generally would result in the following: (1) *Exempt facility bonds where the property is governmentally owned.*—Rent and other user charges paid by any nongovernmental party using the property in a use that was not qualified for tax-exempt financing would not be deductible for Federal tax purposes during the period of nonqualifying use. (2) *Section 501(c)(3) organization bonds.*—The section 501(c)(3) organization would realize unrelated business income in an amount equal to interest incurred on the bond financing during the period of nonqualified use. No offsetting deduction for rent or interest with respect to the property would be permitted.

Item	Present Law	President's Proposal	Possible Option
d. Change in use of nongovernmental bond-financed property—Cont.			(3) *Privately owned exempt-facility property and residences financed with mortgage subsidy bond loans.*—Interest incurred with respect to bond-financed loans would be nondeductible for Federal tax purposes during the period of the nonqualified use. In the case of multifamily housing projects, a 6-month correction period would be permitted, as discussed under B.1.a.(i), above. In the case of single-family housing, interest would be nondeductible only if the mortgagor failed to use the housing as a principal residence for a period in excess of 1 year. *Effective date.*—Changes in use occurring after December 31, 1985, with respect to financing provided (by loan, lease, or other arrangement) after that date.
Volume Limitation on nongovernmental Bonds and Bond Proceeds	***Volume limitations*** Three separate sets of volume limitations are imposed under present law with respect to certain types of nongovernmental bonds. *(1) Limitation on student loan bonds and most IDBs* *Aggregate volume.*—The amount of student loan bonds and most IDBs that may be issued within a State during any calendar year is limited to the greater of $150 for each resident of the State or $200 million. The $150 per capita limitation is scheduled to be reduced to $100 after 1986 to reflect the scheduled sunset of most small-issue IDBs. *Allocation rules.*—Each State's volume limitation is allocated one-half to State issuers and one-half to localities within the State on the basis of relative populations unless the State adopts a statute providing a different allocation. Governors of each State were permitted to issue proclamation overriding the Federal rules during an interim period before State legislatures had met. Each person allocating bond authority must certify that the allocation is not made in consideration of any bribe, gift, or campaign contribution. (A special allocation rule applies for States having constitutional home rule cities.)	No tax exemption for nongovernmental bonds.	***Volume limitation*** A single volume limitation would be imposed with respect to the following bonds issued by States and local issuers therein— (1) *All* nongovernmental bonds with respect to which tax-exemption was permitted (except certain airport facility bonds, discussed below); and (2) The portion of a governmental bond issue in excess of $1 million that was used by persons other than a State or local government. (Under the rules discussed in A., above, the amount of such proceeds used by nongovernmental persons may not exceed an amount equal to the lesser of 5% of proceeds or $5 million.) *Aggregate volume.*—The annual volume of tax-exempt nongovernmental bonds (including the nongovernmental portion of governmental bonds, discussed in (2), above) issued by each State and local issuers therein could not exceed $150 per resident of the State. This per capita limitation would be reduced to $100 per resident after 1987 to reflect the present-law scheduled sunset of tax-exemption for qualified mortgage bonds.

Item	Present Law	President's Proposal	Possible Option
Volume Limitation on Nongovernmental Bonds and Bond Proceeds—Cont.	*Carryforward of bond authority.*—Bond issuers may elect to carry forward unused bond authority for up to three years generally for specific, identified exempt-activity IDB projects, or for the general purpose of issuing student loan bonds. *(2) Qualified mortgage bonds* *Aggregate volume.*—The annual volume of qualified veterans' bonds that may be issued within a State is limited to the greater of (1) 9 percent of the average annual aggregate principal amount of mortgages executed during the three preceding years for single-family, owner-occupied residences located in the State, or (2) $200 million. *Allocation rules.*—Qualified mortgage bond authority is allocated among issuers in each State pursuant to rules like those applicable to student loan bonds and most IDBs. *Carryforward of bond authority.*—States may not carry forward unused qualified mortgage bond authority. *(3) Qualified veterans' mortgage bonds* *Aggregate volume.*—The five States permitted to issue qualified veterans' mortgage bonds are subject to volume limitations based on the volume in which they issued bonds during the period beginning on January 1, 1979, and ending on June 22, 1984. *Allocation rules.*—Qualified veterans' mortgage bonds are general obligation bonds of the issuing State. This bond authority is not allocated to any local governmental issuers. *Carryforward of bond authority.*—States may not carry forward unused qualified veterans' mortgage bond authority. ***Nongovernmental bonds not subject to volume limitations*** No volume limitations are imposed with respect to nongovernmental bonds the proceeds of which are to be used— (1) By section 501(c)(3) organizations; (2) For multifamily rental housing; (3) For governmentally owned airports, docks and wharves, mass commuting facilities, convention centers, and trade show facilities.		Refunding bonds would not be subject to the volume limitation to the extent the amount of the refunding bonds did not exceed the amount of outstanding refunded bonds and did not have a maturity date after expiration of 120% of the economic life of the bond-financed property. *Allocation rules.*—Each State's volume limitation would be allocated one-half to State issuers and one-half to localities within the State on the basis of relative populations unless the State adopted a statute providing a different allocation. Governors of each State would be permitted to issue proclamations overriding the Federal allocation rules, effective during an interim period before State legislatures meet. The present-law required certification by persons allocating bond authority would be repealed. Other administrative provisions of the present IDB volume limitation (including the rules for determining the location of property receiving volume allocations, and the special rule for States having constitutional home rule cities) would apply under the new volume limitation. *Carryforward of bond authority.*—Bond issuers could elect to carry forward unused bond authority for up to three years for specific, identified nongovernmental projects and for the general purpose of issuing either (a) qualified mortgage bonds or (b) qualified veterans' mortgage bonds. *Protection of housing bonds.*—Unless overridden by a State statute, at least 50% (reduced to 25% after 1987 to reflect the sunset of authority to issue qualified mortgage bonds) of each State's annual nongovernmental bond volume limitation would be required to be used for— (i) multifamily rental housing bonds; (ii) qualified mortgage bonds; or (iii) qualified veterans' mortgage bonds. ***Nongovernmental bonds not subject to the volume limitation*** Bonds to finance airport facilities would not be subject to the volume limitation to the extent that the bond proceeds were used to finance— (a) Runways; (b) Air traffic control towers; (c) Terminal facilities and public parking facilities that are not leased to or otherwise operated by a nongovernmental person.

Item	Present Law	President's Proposal	Possible Option
. Volume Limitation on Nongovernmental Bonds and Bond Proceeds—Cont.			*Effective date.*—Bonds issued after December 31, 1985. *Exceptions.*—(1) Bonds presently subject to no State volume limitations but that would be subject to the new limitation if the bonds were with respect to facilities— (a) The original use of which commences with the taxpayer and the construction, reconstruction, or rehabilitation of which began before September 26, 1985, and was completed on or after that date, or (b) With respect to which a binding contract to incur significant expenditures was entered into before September 26, 1985, and part of all of such expenditures were incurred on or after that date. Significant expenditures would be defined as expenditures in excess of 10% of the estimated cost of the facility. Facilities eligible for the exception would be defined as property for which bond financing was approved by a governmental unit (or by voter referendum) before September 26, 1985. (2) Bonds presently subject to State volume limitations that would be subject to the new single limitation to the extent that the bonds are issued pursuant to a carryforward election allowed under current State volume limitation filed before October 31, 1985, if the bonds are issued with respect to facilities satisfying the transitional exceptions in (1) (a) or (b), above.

Item	Present Law	President's Proposal	Possible Option
). Arbitrage Restrictions			
1. Profit limitations and determination of bond yield	Present law includes three sets of arbitrage restrictions applicable to tax-exempt bonds.	The present-law arbitrage rules would be modified as follows:	Same as President's proposal, with the following modifications:
	General restrictions applicable to all tax-exempt bonds	*General restrictions applicable to all tax-exempt bonds*	*General restrictions applicable to all tax-exempt bonds*
	Profit limitations.—If bond proceeds are reasonably expected to be invested in other securities (other than tax-exempt bonds) having a yield that is materially higher than the yield on the bonds, bond interest is taxable. The amount of permitted arbitrage earnings depends on whether the bond proceeds are invested in obligations related to the purpose of the borrowing or in other, nonpurpose obligations, and whether the issuer elects to earn unlimited arbitrage profits for certain temporary periods.	*Profit limitations.*—Clarification would be provided that the reasonable expectations test included in the present-law general arbitrage restrictions does not protect intentional acts to create arbitrage.	*Profit limitations.*—The restriction on investment in higher yielding obligations would be expanded to include investment in annuity contracts and other property held for investment. (This rule would ensure that purchase of 3rd party contracts to fund deferred payment arrangements would be subject to yield restrictions in the same manner as direct funding of these arrangements.)
	Exceptions.—(1) Investments not exceeding a minor portion (15%) of bond proceeds in materially higher yielding obligations. (A reasonably required debt service reserve fund is the most important example of the use of this exception.) (2) Investments during a temporary period prior to use for the purpose of the borrowing. (Generally, this temporary period may not exceed 3 years.)	*Exceptions.*—The right to elect to earn higher arbitrage profits over the entire term of the bonds by foregoing a temporary period when unlimited arbitrage is permitted would be repealed. Temporary periods during which unlimited arbitrage is permitted would be restricted as follows: (a) No temporary period would be permitted for bond issues to finance acquisitions; and (b) For construction projects, the temporary period would end on the earlier of the date— (i) The project was substantially completed; (ii) An amount equal to bond proceeds had been spent on the project; or (iii) Three years after the earlier of the date the bonds were issued or the date construction on the project began.	*Exceptions.*—The present-law minor portion rule would be deleted. The exception for reasonably required debt service reserve funds would be retained. A 30 day temporary period would be permitted for bonds used to finance acquisitions. The allowable temporary period for bonds used for mixed acquisition/construction projects would be determined separately with respect to the portion of the bond proceeds used for each activity.
	Determination of bond yield.—Bond yield is interpreted to mean the discount rate at which all anticipated payments of principal and interest on the bonds equals the net proceeds of the issue after deducting the costs of issuance. (This deduction of issuance costs permits bond issuers to earn a higher yield on the investment of bond proceeds, and thereby to pay issuance costs out of arbitrage profits.)	*Determination of bond yield.*—Bond yield would be determined as under the present-law additional restrictions for most IDBs and all qualified mortgage bonds.	Same as President's proposal.

Item	Present Law	President's Proposal	Possible Option
1. Profit limitations and determination of bond yield—Cont.	*Additional restrictions for most IDBs* *Profit limitations.*—IDBs (other than IDBs for multifamily rental housing) are subject to the following additional arbitrage restrictions: (a) The amount of bond proceeds that may be invested at unrestricted yield in obligations unrelated to the purpose of the borrowing is limited to 150 percent of scheduled annual debt service. (b) The gross earnings on each issue of bonds must be rebated to the Federal Government at specified intervals. *Exceptions.*—The restriction on investment in nonpurpose obligations (item a, above) does not apply to investments for an initial temporary period or to investments for temporary periods related to current debt service (as opposed to reserve funds for future debt service). The rebate requirement does not apply if all bond proceeds are spent for the governmental purpose of the issue within 6 months of issuance of the bonds or to certain debt service funds on which less than $100,000 is earned in a bond year. *Determination of bond yield.*—Bond yield is determined using the original issue discount rules of the Code. (Thus, costs of issuance may not be recovered out of arbitrage profits.)	*Extension of present-law additional IDB restrictions* The present restriction on investment of bond proceeds in obligations unrelated to the purpose of the borrowing and the rebate requirements applicable to most IDBs would be extended to all tax-exempt bonds.	*Extensions of present-law additional IDB restrictions* The present-law additional restrictions on most IDBs would be extended to all tax-exempt bonds other than qualified mortgage bonds and qualified veterans' mortgage bonds.

Item	Present Law	President's Proposal	Possible Option
1. Profit limitations and determination of bond yield—Cont.	*Additional restrictions for qualified mortgage bonds* *Profit limitations.*—The effective rate of interest on mortgage loans provided with qualified mortgage bonds may not exceed the yield on the issue by more than 1.125 percentage points. Investment of qualified mortgage bond proceeds in obligations unrelated to the purpose of the borrowing is restricted in a manner similar to that for most IDBs. Additionally, arbitrage profits must be rebated to the Federal Government or paid or credited to the mortgagors. *Exceptions.*—Exceptions similar to those to the additional restrictions on most IDBs are provided. *Determination of bond yield.*—Bond yield is determined using the original issue discount rules of the Code. (Thus, costs of issuance may not be recovered out or arbitrage profits.) *Additional restrictions for student loan bonds* In 1984, Treasury was directed to prescribe regulations applying additional arbitrage restrictions similar to those now applying to most IDBs to student loan bonds.		*Additional restrictions for qualified mortgage bonds* Qualified mortgage bonds would remain subject to the present-law additional arbitrage restriction and rebate requirement that applies to those bonds in lieu of the expanded IDB-type restrictions. *Additional restrictions for veterans' mortgage bonds* The present-law qualified mortgage bond additional arbitrage restriction and rebate requirement would be extended to qualified veterans' mortgage bonds in lieu of the expanded IDB-type restrictions. *Effective dates.*—Bonds issued after December 31, 1985, except for the restriction on investment of bond proceeds in annuities and similar deferred compensation arrangements purchased from 3rd parties, which would apply to bonds issued after September 25, 1985.

Item	Present Law	President's Proposal	Possible Option
2. Prohibition of advance refundings	Bonds other than IDBs and mortgage sudsidy bonds may be advance refunded. IDBs and mortgage subsidy bonds may not be refunded more than 180 days before the refunded bonds are redeemed. An exception waives this 180-day rule in the case of refunded bonds having a maturity of less than 3 years.	Interest on advance refunding bonds would be taxable. Advance refundings would be defined to include all refundings where the refunded bonds were not redeemed immediately upon issuance of the refunding bonds.	Same as the President's proposal, except would permit a 30-day period from issuance of the refunding bonds in which to redeem the refunded bonds. *Effective date.*—Bonds issued after December 31, 1985.
3. Restriction on early issuance of bonds	No separate rules require that bond proceeds be spent within a specified period following issuance; however, issuers are required to proceed with "due diligence" to realize the governmental purpose of the borrowing. Additionally, arbitrage profits on most IDBs and on qualified mortgage bonds must be rebated to the Federal Government in certain cases.	Five percent or more of bond proceeds would be required to be spent for the purpose of the borrowing within 30 days after bond issuance. All bond proceeds (other than costs of issuance and amounts in a reasonably required reserve fund) would have to be spent no later than 3 years after bond issuance.	Same as the President's proposal, except would permit the Treasury to extend the 30-day or 3-year period during which bond proceeds were required to be spent in cases where undue hardship otherwise would result (i.e. where delay results from events such as Acts of God). *Effective date.*—Bonds issued after December 31, 1985.
. Information Reporting Requirement for All Tax-Exempt Bonds	Issuers of private activity bonds (defined as IDBs, student loan bonds, and bonds for section 501(c)(3) organizations) and mortgage subsidy bonds are required to report certain information about volume and users of bond-financed facilities to Treasury.	The present-law information reporting requirements for bonds other than mortgage subsidy bonds would be extended to all tax-exempt bonds. (The proposal includes no separate provision for reporting on mortgage subsidy bonds since tax-exemption for those bonds would be repealed.)	Same as the President's proposal, except for a modification providing that the present-law information reporting requirements for mortgage subsidy bonds would continue to apply to those bonds (in lieu of the private activity bond requirements). *Effective date.*—Bonds issued after December 31, 1985.
. General Stock Ownership Corporation Provisions	States may establish General Stock Ownership Corporation (GSOC) that serves as an investment fund for its citizens. GSOCs may elect to be exempt from tax with the shareholders reporting as income their pro-rata share of the GSOC's taxable income. (No State has used this provision).	Repeals the GSOC provision as "deadwood." *Effective date.*—January 1, 1984.	Same as President's proposal.

Item	Present Law	President's Proposal	Possible Option
Reserves for Bad Debts **1. Commercial banks**	Commercial banks are allowed to deduct loan losses prior to the time that loans become wholly or partially worthless using either of two reserve methods: (1) the experience method and (2) the percentage of eligible loans method. The availability of the percentage of eligible loans method is scheduled to expire for taxable years beginning after 1987. If the bad debt deduction computed under the percentage of eligible loans method exceeds the deduction that would have been allowed under the experience method, then the deduction is reduced by 20 percent of such excess, and 59⅛ percent of the deductible excess (after the 20-percent reduction) is treated as a tax preference item for purposes of the corporate minimum tax.	The use of both the experience and percentage of eligible loans methods would be repealed. Deductions for bad debts would be allowed when the loans are partially or wholly worthless (i.e., the "specific charge-off" method). *Effective date.*—Taxable years beginning after 1985. The existing balance in the reserve for bad debts as of the effective date would be included in income ratably over a 10-year period, starting with the first taxable year beginning after 1985. Banks could elect to include the entire reserve balance in income in the first taxable year beginning after 1985.	Same as President's proposal. *Effective date.*—Taxable years beginning after 1985. The existing reserve balance on the effective date would be included in income ratably over a 6-year period starting with the first taxable year beginning after 1985. Taxpayers could elect the amount to be recaptured in the first taxable year beginning after 1985, and ratably recapture the balance over the next 5 years.
2. Thrift institutions *a. General rule*	Thrift institutions may deduct loan losses, prior to the time that loans become wholly or partially worthless, using the reserve methods available to banks (the "experience" and "percentage of eligible loans" methods) or the "percentage of taxable income" method, which is available only to thrifts. The percentage of eligible loans method is scheduled to expire for taxable years beginning after 1987. Under the percentage of taxable income method, an annual deduction is allowed for 40 percent of taxable income if 82 percent of the thrift's assets are qualified (72 percent for mutual savings banks without stock). The deduction phases down to zero when less than 60 percent of the thrift's assets are qualified (50 percent for mutual savings banks without stock). Qualified assets include home mortgage loans and certain other assets.	Use of the experience, percentage of eligible loans, and percentage of taxable income methods would be repealed. Deductions for loan losses would be allowed when the loans are partially or wholly worthless (i.e., the "specific charge-off" method). *Effective date.*—Taxable years beginning after 1985. The portion of the bad debt reserve on the effective date which is equal to the greater of the reserve balance computed under the experience and percentage of eligible loans methods would be included in income ratably over a 10-year period starting with the first taxable year beginning after 1985. Taxpayers could elect to include the entire recapture amount in the first taxable year beginning after 1985.	Same as President's proposal. *Effective date.*—Taxable years beginning after 1985. The recapture amount is the greater of the reserve balance computed (1) under the experience method (as of December 31, 1985), and (2) under the percentage of eligible loans method (as of June 30, 1985). The recapture amount would be included in income ratably over 6 years, starting with the first taxable year beginning after 1985. Taxpayers could elect the amount to be recaptured in the first year beginning after 1985, and ratably recapture the balance in the next 5 years.

Item	Present Law	President's Proposal	Possible Option
Thrift institutions—Cont.			*Elective cut-off method for thrifts.*—As an alternative to recapture, thrifts could elect to retain the reserve method for loans originated or acquired before 1986. Losses on existing loans (including collateral property) would be charged off against bad debt reserves to the extent of the recapture amount. Losses in excess of the recapture amount would be deductible from gross income. However, sale or disposition of existing loans would trigger inclusion in income of a pro rata share of the recapture amount.
b. Recapture of excess distributions	Distributions in excess of earnings and profits (accumulated after 1951) are treated as made out of bad debt reserves (to the extent such reserves exceed the amount of reserves determined using the experience method). Such distributions are included in the gross income of the payor and are taxed as dividends to the recipient.	Unclear.	Retained for reserves accumulated as of the effective date.
c. Preference cutback and minimum tax	If the bad debt deduction exceeds the deduction that would have been allowed under the experience method, then the deduction is reduced by 20 percent of such excess, and 59⅚ percent of the deductible excess (after the 20-percent reduction) is treated as a tax preference item for purposes of the corporate minimum tax.	Repealed.	Same as President's proposal.
Interest on Debt Used to Purchase or Carry Tax-Exempt Obligations	No deduction is allowed for interest payments on debt incurred or continued to purchase or carry tax-exempt obligations. Under a long-standing judicial and administrative interpretation, financial institutions generally are permitted to invest deposited funds in tax-exempt obligations, while continuing to deduct interest paid to depositors. The corporate tax preference rules reduce by 20 percent the amount which may be deducted by financial institutions for interest on funds allocable to tax-exempt obligations acquired after 1982. The portion of funds allocable to tax-exempt obligations is deemed to be equivalent to the ratio of— (i) the average annual adjusted basis of tax-exempt obligations acquired after 1982 and held by the financial institution, to (ii) the average annual adjusted basis of the financial institution's total assets.	Denies financial institutions 100 percent of interest deductions that are allocable to tax-exempt obligations acquired on or after January 1, 1986. The amount of interest allocable to tax-exempt obligations would be determined in the same manner as for purposes of the tax preference reduction under present law. The present law (i.e., 20 percent) reduction would continue to apply with respect to tax-exempt obligations acquired in 1983 through 1985.	Same as the President's proposal, with clarifications regarding coordination of the 100-percent disallowance rule with other rules prescribing special treatment of interest deductions (e.g., construction period interest rules and rules regarding foreign source income).

Item	Present Law	President's Proposal	Possible Option
Reorganizations of Financially Troubled Thrift Institutions			
1. Qualification for tax-free status	Continuity of proprietary interest is generally a prerequisite to qualification of a transaction as a tax-free reorganization. The Code contains a special provision under which a merger of a financially troubled thrift institution into another corporation may qualify as a reorganization even though continuity of proprietary interest is absent.	The special rules relating to qualification of an acquisition of a financially troubled thrift as a tax-free reorganization would be repealed. *Effective date.*—January 1, 1991.	Same as President's proposal, except the repeal would be effective January 1, 1986.
2. Net operating losses	The rules limiting use of an acquired corporation's net operating loss carryovers by the acquiring corporation are relaxed in certain situations for troubled thrift reorganizations.	The special treatment of net operating losses in a troubled thrift reorganization would be repealed. *Effective date.*—January 1, 1991.	Same as President's proposal, except repeal would be effective January 1, 1986.
3. FSLIC payments	Payments received by certain financially troubled thrifts from the Federal Savings and Loan Insurance Corporation (FSLIC) are not income to the recipient and are exempt from the general requirement that a taxpayer's basis in its assets be reduced by nonshareholder contributions to capital.	The special rules relating to the exclusion from income, or exemption from the basis reduction requirement, of FSLIC payments to troubled thrifts would be repealed. *Effective date.*—January 1, 1991.	Same as President's proposal, except repeal would be effective January 1, 1986. In addition, present law would be clarified by providing that FSLIC payments to financially troubled thrifts exempt under the present-law exclusion are not subject to the provision disallowing expenses attributable to such payments.
Credit Unions	Credit unions are exempt from Federal income tax.	Repeals tax exemption for credit unions having assets of $5 million or more. Taxable credit unions would be subject to the same general tax rules as would apply to thrift institutions (e.g., savings and loan associations and mutual savings banks). *Effective date.*—Taxable years beginning on or after January 1, 1986.	Same as President's proposal. *Effective date.*—Same as President's proposal; special transitional rules would be adopted to ensure that, to the extent possible, credit unions are taxed only on post-1985 income.

Item	Present Law	President's Proposal	Possible Option
E. Special Rules for Net Operating Loss Carryovers of Depository Institutions	Commercial banks and thrift institutions may carry net operating losses back to the preceding ten taxable years and forward to the succeeding five taxable years. This contrasts with the general rule for other taxpayers allowing a net operating loss to be carried back to the preceding three taxable years and forward to the succeeding 15 taxable years.	The special carryback and carryforward rules applicable to commercial banks and thrift institutions would be repealed. Commercial banks and thrift institutions would carryback and carryforward net operating losses under the general rule applicable to other taxpayers (3-year carryback; 15-year carryforward). *Effective date.*—Change applies to net operating losses incurred in taxable years beginning on or after January 1, 1986. Net operating losses incurred in earlier years would continue to be subject to the rules of present law.	Same as President's proposal.

Item	Present Law	President's Proposal	Possible Option
A. Limitations on the Use of the Cash Method of Accounting	A taxpayer may elect to use any method of accounting that clearly reflects income and is regularly used in keeping its books. The cash receipts and disbursements method (the cash method) generally is considered to clearly reflect income for Federal income tax purposes under present law, except where inventories are required to be kept.	Any taxpayer with annual gross receipts from a business exceeding $5 million, computed on a 3-year moving average basis, would not be permitted to use the cash method of accounting for Federal income tax purposes. For businesses other than farming, use of the cash method also would be disallowed if another method of accounting has been used regularly to ascertain the income, profit or loss of the business for the purpose of reports or statements to shareholders, partners, other proprietors, beneficiaries, or for credit purposes. The proposal would apply in addition to the current law limitation on the use of the cash method with respect to a business in which inventory accounting is required. *Effective date; transition rules.*—Taxable years beginning on or after January 1, 1986. The adjustment to income resulting from the change in tax accounting method would be recognized ratably over a period not to exceed six years beginning with the first tax year for which the proposal is effective.	Same as President's proposal except— Accrual of income items would be limited to amounts which are statistically determined to be collectible, unless interest or a late payment charge is separately stated on the income item. Use of the cash method by businesses under $5 million annual gross receipts would not be denied by reason of the business having provided any report to a creditor, containing amounts determined using a method of accounting other than the cash method, if the report is made on or in accordance with a form or model required by the creditor, except if such reports are regularly made to creditors. Computation of annual gross receipts would be done on the basis of the previous three taxable years (not including the current taxable year).
B. Pledges of Installment Obligations	Taxpayers who receive an installment obligation in exchange for property may report gain in proportion to payments received on the obligation. If installment obligation is disposed of, deferred gain generally is recognized. If installment obligation is pledged as collateral for a loan, deferred gain generally recognized only as payments on obligation are received. Effect is that taxpayers who have pledged installment obligations (such as some home builders and retailers, for example) continue deferral even though (a) cash equal to most of face amount may have been received, (b) payments on obligation may be devoted to loan repayment, and (c) the taxpayer may treat pledge as disposition for financial accounting purposes.	*General rule.*—If installment obligation is pledged for a loan, proceeds of loan generally would be treated as payment on the obligation and proportionate amount of deferred gain would be recognized. *Special rule for dealer property.*—If installment obligation received for property sold in the ordinary course of a trade or business is pledged for loan in ordinary course of trade or business, proceeds of loan trigger gain to the extent loan proceeds exceed basis of the obligation. *Subsequent payments.*—Payments by obligor on installment obligation would trigger additional gain to the extent that the gain attributable to such payments exceeds gain recognized on account of the pledge. *Exceptions.*—Inapplicable to pledge of obligation that by its terms is due within 12 months, or obligation received under a revolving credit plan that contemplates all purchases would be paid for within 12 months. Also inapplicable to pledge of obligations for debt that by its terms is payable within 90 days, provided that debt is not renewed or continued.	Same as President's proposal except— (a) Treat pledges of installment obligations received for property sold in the ordinary course of a trade or business the same as pledge of other installment obligations under proposal. (b) Provide exception for any installment payment that are due within six months, regardless of the maturity of other payments on the obligation. For a taxpayer who sells property on a revolving credit plan, the amount eligible for the exception would be that portion of the receivable balance that is determined (pursuant to a statistical sampling technique) to be paid in six months.

Item	Present Law	President's Proposal	Possible Option
Pledges of Installment Obligations—Cont.		*Effective date.*—Applicable to obligations pledged after December 31, 1985. Any installment obligation pledged before January 1, 1986, is treated as pledged on January 1, 1991, if still outstanding.	(c) Allow exception for 90-day debt only if taxpayer does not issue additional debt within 45 days. (d) Provide anti-avoidance rules, including: (i) entity look-through rules, e.g., treat pledge of stock of subsidiary as pledge of the subsidiary's assets; (ii) limit general lien exception, and include unsecured loans, where receivables constitute significant basis for the borrowing; and (iii) include other indirect pledges in scope of provision. *Effective date.*—Applicable to obligations pledged after December 31, 1985, and applicable as of January 1, 1986, to obligations created after September 25, 1985, if pledged for a debt outstanding after December 31, 1985. Any installment obligation created before September 26, 1985, and pledged before January 1, 1986, is treated as pledged on January 1, 1991, if still outstanding.
. Accounting for Production Costs			
1. In general	Producers of tangible property generally may not deduct currently costs incurred in producing the property, but must capitalize these costs and recover them through an offset to the sales price (in the case of property produced for sale) or through depreciation or amortization (in the case of property constructed by the taxpayer for use in its business). While substantially all direct production costs must be capitalized, the treatment of indirect costs may vary depending on the type of property produced (inventory goods, nonfungible property held for sale to customers, property produced under a long-term contract, farm products, timber, etc.).	The comprehensive capitalization requirements applicable to extended period long-term contracts would apply to all activities involving the production or manufacture of real or personal property. The effect of the proposal would be that a number of costs now deductible currently would be capitalized and treated as product costs (in the case of inventory goods), costs attributable to a long-term contract (in the case of a contract reported under the completed contract method), or the basis of the property (in the case of self-constructed assets).	Same as President's proposal, except for long-term contracts (see below).

Item	Present Law	President's Proposal	Possible Option
1. In general—Cont.	*Long-term contract costs.*—The most comprehensive capitalization requirements apply to "extended period" long-term contracts reported under the completed contract method; most of the contractor's indirect costs (including all tax depreciation, pension and freeze benefit costs and certain allocable general and administration expenses), as well as direct costs, must be capitalized and allocated to a particular contract. A long-term contract is a construction or manufacturing contract spanning 2 or more taxable years; and extended period long-term contract is one not expected to be completed within 2 years, excluding real property construction contracts (1) entered into by a contractor with average annual gross receipts of $25 million or less or (2) expected to be completed within 3 years. Somewhat less comprehensive capitalization requirements apply to non-extended period long-term contracts.	*Long-term contract costs.*—In addition to costs required to be capitalized under the general rules, all general and administrative costs attributable to cost-plus contracts, and to Federal government contracts requiring certification of costs, would be subject to capitalization.	
2. Farming and ranching costs	The Code and regulations provide exceptions from the otherwise applicable tax accounting rules for certain farmers and ranchers. For example, certain farmers and ranchers may elect to use the cash method of accounting when the accural method would otherwise be required, may use simplified inventory methods if an accrual method is adopted, and may deduct currently certain preproductive costs that would otherwise have to be capitalized.	A special rule would apply to farmers and ranchers not required to capitalize preproductive costs under present law. In general, such persons would be required to capitalize production costs only in the case of plants or animals having a preproductive period of 2 years or longer.	Same as President's proposal.
3. Interest	Interest incurred by a taxpayer during construction or improvement of real property to be used in a business or held for profit generally must be capitalized and amortized over 10 years.	The proposal would require capitalization of interest on debt incurred to finance the construction or production of (1) long-lived personal and real property to be used by the taxpayer in a trade or business or an activity for profit, or (2) other tangible property requiring 2 or more years to produce or construct, or to reach a productive stage.	Same as President's proposal.
4. Timber	Some costs of producing timber, such as planting costs and costs incurred before the seedlings are established, must be capitalized and recovered when the timber is sold. Most other costs may generally be deducted currently.	The comprehensive capitalization requirements, including capitalization of interest, would apply to timber.	

Item	Present Law	President's Proposal	Possible Option
5. Effective date		*Effective date.*—In general, costs and interest incurred after December 31, 1985. Production costs (including interest) attributable to timber planted before 1986 would be subject to capitalization under a 10-year phase-in rule (10 percent of such costs incurred in 1986 would have to be capitalized, 20 percent in 1987, etc.). For inventories, the rules would apply to taxable years beginning on or after January 1, 1986, with a 6-year spread of the adjustment resulting from the change in accounting method. The new rules would not apply to long-term contracts entered into before 1986.	Same as President's proposal, except that the phase-in period for timber would be 5-years.
D. Income From Long-Term Contracts	A taxpayer providing goods under a long-term contract may elect to report income from such contracts under the completed contract method, under which the entire gross contract price is included in income in the year in which the contract is completed and accepted. Costs allocable to the contract are also accumulated and deducted in that year.	None.	Require the use of the percentage of completion method for contracts entered into on or after September 25, 1985. Interest would be payable by (or to) the taxpayer if the actual profit on the contract varies from the estimated profit used in reporting income.
E. Special Treatment of Certain Items 1. Reserves for bad debts	A taxpayer may take a deduction for losses on business debts under the "reserve method" (sec. 166(c)). The "reserve method" allows a current deduction for that portion of business debts currently owed the taxpayer which are expected to become uncollectible. A similar rule applies to debt that is guaranteed by a dealer in property where the debt arises from the sale of tangible property and related services in the ordinary course of business.	The use of the reserve method in computing the deduction for bad debts would be disallowed. Instead, deductions for bad debts would be allowed when specific loans become partially or wholly worthless (i.e., the "specific charge-off" method). Wholly worthless debts would have to be treated as worthless on a taxpayer's books in order for a deduction to be allowed for Federal income tax purposes, as is the case under present law for partially worthless debts. Retains present law on guarantees by a dealer in property. *Effective date.*—Taxable years beginning on or after January 1, 1986. The balance in any reserve for bad debts at that time would be included in income ratably over a 10-year period beginning with the first taxable year beginning on or after January 1, 1986.	Same as President's proposal except— In order to provide more consistency with other transitional rules for accounting method changes, the period over which any reserve for bad debts is included in income would be changed to six years. The use of the reserve method in computing the deduction for losses on debts guaranteed by a dealer would also be disallowed. Any balance in such a reserve would be included in income in the same manner as a balance in a reserve for bad debts.

Item	Present Law	President's Proposal	Possible Option
2. Mining and solid waste reclamation costs	Taxpayers may elect a special reserve method for deducting qualified mine and waste disposal reclamation and closing costs prior to economic performance. Taxpayers who do not elect this method are subject to the general rules of the Code that do not permit accrual-basis taxpayers to deduct expenses prior to the time when economic performance occurs.	The special reserve method for mine and waste disposal reclamation and closing costs would be repealed. Thus, such costs generally would be deductible only as the sites are closed or the land reclaimed (i.e., when economic performance occurs). *Effective date.*—The proposal would be effective for mining or production activity on or after January 1, 1986. The Administration proposal does not indicate whether elections made before 1986 would be revoked.	Retain present law.
3. Accrued vacation pay	Under present law, an accrual method taxpayer generally is permitted a deduction no earlier than the taxable year in which the all-events test is met and economic performance occurs. In the case of deferred benefits for employees (such as vacation pay earned in the current taxable year, but paid more than 2½ months after the close of the current year), an employer generally is entitled to claim a deduction only when the benefit is includible in an employee's gross income. Under a special rule of present law, an employer may make an election under section 463 to deduct an amount representing a reasonable addition to a reserve account for vacation pay (contingent or vested) earned by employees in the current year and expected to be paid by the close of that year or within 12 months thereafter.	None.	The special provision under present law relating to accrued vacation pay would be repealed. Under the usual rules for benefits earned but not paid during the current taxable year, an employer's deduction for vacation pay would be deferred until an employee includes the vacation pay in gross income. *Effective date.*—The proposal would be effective for taxable years of the employer beginning after December 31, 1985.

Item	Present Law	President's Proposal	Possible Option
4. Returns of magazines, paperbacks and records	An accrual-basis taxpayer may elect to exclude from gross income amounts attributable to "qualified sales" of magazines, paperbacks or records which are repaid or credited to the purchaser before the close of the "merchandise return period" (sec. 458). A "qualified sale" is a sale for which, at the time of the sale, the taxpayer has a legal obligation to adjust the sales price of the item if it is not resold, and which is in fact so adjusted. The merchandise return period is two months and 15 days following the close of the taxable year for magazines, and four months and 15 days following the close of the taxable year for paperbacks and records. For the first year to which an election applies, special rules delay a portion of the exclusion to limit the bunching of exclusions that might otherwise occur.	The election to exclude from gross income amounts attributable to the qualified sales of magazines, paperbacks or records which are repaid or credited after year end, but before the close of the merchandise return period, would be repealed. Any amount of exclusion delayed in the first year of election, which has not yet been allowed as an exclusion, would be treated as a deduction in the first taxable year for which the proposal is effective. *Effective date.*—Taxable years beginning on or after January 1, 1986.	Same as President's proposal.
5. Qualified discount coupons	An accrual-basis taxpayer may elect to deduct the cost of redeeming "qualified discount coupons" outstanding at the close of the taxable year and received for redemption up to six months following the close of the taxable year (sec. 466). A "qualified discount coupon" is one which is issued and redeemable by the taxpayer and which allows a discount of not more than $5 on the purchase price of merchandise or other tangible personal property. For the first year to which an election applies, a special rule delays a portion of the deduction attributable to the election to prevent a bunching of deductions.	The election to deduct the cost of redeeming "qualified discount coupons" received after the close of the taxable year would be repealed. Any portion of the delayed deduction from the first year of election, which has not yet been allowed as a deduction, would be deductible in the first taxable year for which the proposal is effective. *Effective date*—The proposal would be effective for taxable years beginning on or after January 1, 1986.	Same as President's proposal.

Item	Present Law	President's Proposal	Possible Option
Insurance Products			
1. Life insurance products			
a. Inside buildup	The cash value of a life insurance policy earns interest ("inside buildup") that is credited to the account of the policyholder and is not taxed as current income to the policyholder. This income is never taxed if the proceeds of the policy (including income credited to the policy) are paid to the policy's beneficiary after the death of the insured. Taxation of the inside buildup is only deferred to the extent that a policy is not cashed in (or surrendered) in exchange for its cash surrender value.	A life insurance policyholder would annually include in income any increase in the excess of the policy's cash surrender value over the investment in the contract during the taxable year. Policyholders with variable life insurance policies would be taxed on a proportionate share of realized gains and other income earned on assets of the separate account underlying the variable policy. *Effective date.*—The proposal would be effective after December 31, 1985, for inside buildup credited to policies issued on or after the date of committee action. For policies issued before the date of committee action, inside buildup would continue to be exempt from tax to the extent the death benefit is not increased above the sum of the death benefit on the date of committee action and any additional death benefit required for the policy to continue to qualify as a life insurance contract for purposes of Federal tax law.	Retain present law.
b. Policyholder loans and partial withdrawals	Life insurance policies often permit the policyholder to borrow up to the cash surrender value of the policy. Until repaid, the policyholder loan reduces the proceeds payable to the policyholder in the event of a surrender of the policy or to the beneficiaries in the event of the death of the policyholder. Under present law, policyholder loans generally are treated as loans and not as withdrawals from the policy. Interest paid on policyholder loans generally is deductible by the policyholder even though the policy's inside buildup has not been included in taxable income. Any amount withdrawn from a life insurance policy as a "partial surrender" of the policy is treated first as a nontaxable return of the policyholder's investment in the contract. Only after the policyholder fully recovers the investment in the contract will amounts withdrawn from the policy be subject to tax.	The President's proposal did not recommend any specific changes relating to the tax treatment of policyholder loans. However, the President's proposal would generally limit the deduction for nonbusiness interest to the sum of net investment income, interest on debt secured by the taxpayer's principal residence (up to its value), and $5,000.	Modify present law to provide that policy loans are treated in the same manner as loans from qualified pension plans. Thus, policyholder loans would be treated as distributions of income to the policyholder to the extent of any unrealized income credited to the policy. An exception would be provided to the extent that the outstanding loan balances for an individual policyholder do not exceed $50,000, and the conditions of the loans require repayment within five years. For purposes of computing the amount of income realized by the policyholder on a loan treated as a distribution, the distribution would be treated as made first out of income on the contract. Interest payments to an insurance company on a policyholder loan would be treated as a nondeductible premium payment.

Item	Present Law	President's Proposal	Possible Option
b. Policyholder loans and partial withdrawals (cont.)		*Effective date.*—The nonbusiness interest limitation generally would be effective (subject to two phase-in rules) for interest expense paid or incurred after December 31, 1985.	*Effective date.*—The proposal generally would apply only to loans made from policies issued after September 25, 1985. However, the $50,000 limit on outstanding loan balances would be computed for any policyholder by taking into account the outstanding balance of any loans made before the effective date.
c. Exclusion for interest on installment payments of life insurance proceeds	A beneficiary of a life insurance policy may receive installment payments of the proceeds of the policy. Amounts in the nature of interest (up to $1,000 annually) on the unpaid proceeds of the policy paid to the surviving spouse of the insured are not included in the spouse's income.	None.	Repeal the $1,000 annual exclusion for the amounts in the nature of interest received by the surviving spouse of an insured. *Effective date.*—The proposal generally would be effective after December 31, 1985.
2. Other policyholder issues			
a. Deduction for policyholder losses	A taxpayer generally may deduct a loss sustained during the taxable year and not compensated for by insurance or otherwise. If a casualty or other event occurs which results in a loss, and the taxpayer has a claim for reimbursement with respect to which there is a reasonable prospect of recovery (such as an insurance claim), then the loss may not be deducted until it can be ascertained with reasonable certainty that the reimbursement will not be received. The casualty loss deduction is allowable only to the extent that the losses exceed 10 percent of the taxpayer's adjusted gross income (AGI). Some recent cases have held that the deduction is allowable when an individual has insurance coverage on nonbusiness property, but elects not to file a claim.	Under the President's proposal, taxpayers suffering losses covered by insurance would be permitted to elect to claim a deduction with respect to those losses without regard to the prospect of recovery from the insurance company. Insurance proceeds would be taxable income when received to the extent of any portion of the loss that was previously deductible. Present law would continue to apply to nonelecting taxpayers. *Effective date.*—The proposal would be effective for all losses incurred in taxable years beginning after December 31, 1985, that are insured under policies issued after December 31, 1985.	Retain present law, but deny the casualty loss deduction to the extent that an individual has insurance coverage on nonbusiness property and elects not to file a claim. *Effective date.*—The proposal would be effective for taxable years beginning after December 31, 1985.

Item	Present Law	President's Proposal	Possible Option
2. Other policyholder issues—Continued *b. Structured settlements*	Present law excludes from income the amount of any damages received on account of personal injuries or sickness, whether by suit or agreement and whether as a lump sum or as periodic payments. The person liable to pay the damages may assign to a third party (a structured settlement company) the obligation to pay the periodic payments. The portion of the amount received by that third party for agreeing to the assignment that is used to purchase assets to fund the liability is not included in that party's income. The overall effect of these rules is that no taxpayer is subject to tax on the investment income earned on assets used to fund the periodic payment of damages for personal injuries.	Under the President's proposal, third-party assignees of liabilities to make periodic personal injury damage payments would include the full amount of consideration received from the assignor in gross income. An assignee purchasing an annuity contract to fund its liabilities to an injured party would be treated as the owner of the annuity and would be taxed on the income component of all amounts paid to it under the terms of the annuity contract. The assignee would be given an election concerning the tax treatment (i.e., the timing of its deduction). *Effective date.*—The proposal would be effective for all assignments entered into after December 31, 1985.	Same as President's proposal.

Item	Present Law	President's Proposal	Possible Option
:. Life Insurance Companies			
1. Reserves	Life insurance companies generally are allowed a deduction for any net increase in reserves in a calendar year. The deduction for an increase in reserves takes into account increases due to both premiums and interest credited to the reserves. The net increase (or net decrease) in reserves is computed by comparing the closing balance to the opening balance for reserves in the same year. For purposes of determining life insurance company taxable income, life insurance reserves for any contract are the greater of the net surrender value of the contract or the reserves determined under Federally prescribed rules.	Under the President's proposal, the reserve held for any life insurance contract would be limited generally to the net cash surrender value of the contract. Thus, a life insurance company would be allowed annually to add to its reserves, policy by policy, only the amount that the net cash surrender value increases. In addition, the proposal would treat the reserves of life insurance companies (not included in life insurance reserves) in the same manner as the reserves of property and casualty companies. The QRA method would apply for purposes of calculating a life insurance company's deduction for unpaid losses. *Effective date.*—The proposal would be effective with respect to policies sold or losses incurred with respect to policies issued after December 31, 1985.	Retain present law.
2. Special deductions	A life insurance company is taxed at corporate rates on its life insurance company taxable income (LICTI). A special life insurance company deduction and a small life insurance company deduction have the effect of reducing the tax rates imposed on LICTI.		
	Small company deduction.—The small life insurance company deduction is 60 percent of tentative LICTI up to $3 million, and it is reduced by 15 percent of tentative LICTI that exceeds $3 million. The maximum deduction allowed is $1.8 million, and it phases out so that it becomes zero at $15 million of tentative LICTI. Only life insurance companies with gross assets of less than $500 million are allowed to take this deduction.	*Small company deduction.*—Repeal present law.	*Small company deduction.*—Revise the present-law small company deduction to permit a deduction for 50 percent of tentative LICTI up to $1 million. This deduction would be reduced by 12.5 percent of the amount by which tentative LICTI exceeds $1 million. The maximum deduction would be $500,000, and it phases out so that it becomes zero at $5 million of tentative LICTI. Only life insurance companies with gross assets of less than $100 million would be allowed to take this deduction.
	Special life insurance company deduction.—A life insurance company is also allowed a special life insurance company deduction of 20 percent of its tentative LICTI (in excess of the small company deduction) for any taxable year. General corporate tax rates apply to LICTI after reduction by the deductions.	*Special life insurance company deduction.*—Repeal present law.	*Special life insurance company deduction.*—Same as the President's proposal.
		Effective date.—The proposal would be effective for taxable years beginning after December 31, 1985.	*Effective date.*—Same as the President's proposal.

Item	Present Law	President's Proposal	Possible Option
3. Tax-exempt organizations engaged in insurance activities	For certain tax-exempt organizations, the provision of insurance benefits to members or to the general public forms the basis for the organization's exemption from Federal income tax. *Charitable organizations.*—A charitable organization directly engaged in providing insurance generally would be considered to be conducting a commercial activity which benefits a private, rather than public, interest and which would endanger the organization's tax exemption. Past IRS policy has permitted certain organizations, which provide life insurance, health insurance, and annuities to be treated as tax exempt. *Social welfare organizations.*—An organization is entitled to tax exemption if it is operated exclusively for the promotion of social welfare. Some health insurance providers have been treated as tax-exempt social welfare organizations. *Fraternal beneficiary societies.*—A fraternal beneficiary society, order, or association that is operating under the lodge system, and providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents is entitled to tax exemption.	None.	An organization directly engaged in providing insurance would not be entitled to tax exemption as a charitable or social welfare organization, unless the organization provided insurance at less than cost to a class of charitable recipients. An organization considered to be directly engaged in providing insurance would include an organization engaged in providing health insurance through indemnification of policyholders. In addition, any fraternal beneficiary society with annual gross premiums greater than $25 million would not be entitled to tax exemption. Those organizations directly engaged in providing insurance would be treated as mutual life or property and casualty insurance companies, depending on the character of their businesses. *Effective date.*—The proposal would be effective for years beginning after December 31, 1985.

Item	Present Law	President's Proposal	Possible Option
. Property and Casualty Insurance Companies **1. Loss reserve deductions of property and casualty insurance companies**	A property and casualty insurance company may deduct from its gross income the losses incurred for the year. Losses incurred include unpaid losses and losses that have been incurred but not reported ("IBNR" losses), which represents the full amount of actual and estimated insurance losses it expects to pay. The deduction is allowed in the year the losses are incurred or estimated to have been incurred, rather than the year in which they are paid or have accrued under generally applicable principles of tax accounting. This loss reserve deduction rule does not take account of the difference between the time the reserve for losses incurred is established (i.e., the year in which the event covered by insurance occurs) and the time when the items are released from the reserve (i.e., the year in which claims are satisfied or otherwise extinguished).	Under the proposal, a property and casualty insurance company's deduction for unpaid losses with respect to a line of business during a taxable year would be limited to the amount it credits to a qualified reserve account ("QRA") for that line of business. If the total amount credited to a QRA exceeds the statutory reserves for the line of business for which the QRA is established in any year, the excess must be currently included in the company's income. The President's proposal is equivalent to discounting reserve deductions to reflect the time value of money. This is accomplished by increasing each QRA reserve annually by a percentage equal to the after-tax rate of return earned by the company on its investments during that year. No additional reserve deduction would be allowed for this annual increase in the reserve accounts. A company would be allowed a deduction each year for the full amount paid to satisfy claims, but would be required to include in taxable income an equivalent amount released from the appropriate QRA. Thus, if the reserve was insufficient to cover all claims, the excess claims would produce a net deduction when paid. *Effective date.*—The proposal would be effective for all losses incurred in taxable years beginning after December 31, 1985, that are insured under policies issued after December 31, 1985.	The proposal would adopt the following provisions as an alternative to the President's proposal for QRA treatment of loss reserves: a. *Treatment of acquisition expenses.*—Include in income of a property and casualty company 20 percent of the annual increase (if any) in the unearned premium reserve. *Effective date.*—The proposal would be effective for increases in unearned premiums in taxable years beginning after December 31, 1985. b. *Treatment of tax-exempt income.*—Reduce deductions for loss reserves by 15 percent of the sum of (a) tax-exempt interest income and (b) the deductible portion of dividends received. *Effective date.*—The proposal would be effective for interest and dividends paid after December 31, 1985. c. *Limit on consolidation.*—Limit the losses of each property and casualty insurance company which may be deducted in determining consolidated taxable income of affiliated corporations to 35 percent of the losses for the year, or 35 percent of the taxable income of nonproperty and casualty insurance affiliates (whichever is less). *Effective date.*—The proposal would be effective for consolidated taxable years beginning after December 31, 1985, and before January 1, 1989. d. *Limit on net operating losses.*—Limit the amount of net operating loss carryovers (NOL's) that may be applied against a property and casualty insurance company's current income to the lesser of (i) 35 percent of such NOL's or (ii) 35 percent of the company's taxable income (determined without regard to such NOL's). NOL's (in excess of the limit) that would otherwise expire during the taxable year may be applied against current income without regard to the limit.

Item	Present Law	President's Proposal	Possible Option
1. Loss reserve deductions of property and casualty insurance companies (Cont.)			*Effective date.*—The proposal would be effective for taxable years beginning on or after December 31, 1985, and before January 1, 1989. e. *Cash method of accounting.*—Require property and casualty insurance reserves, including accident and health reserves, to be computed by applying the cash receipts and disbursements method of accounting for purposes of computing underwriting income and loss. *Effective date.*—The proposal generally would be effective for taxable years beginning after December 31, 1988. However, the application of the cash method of accounting would be ratably phased in to approximate the amount of increased budget receipts estimated under the President's proposal for the qualified reserve account method for fiscal years 1989–1993.
2. Limiting policyholder dividend deduction for mutual companies	Under present law, property and casualty insurance companies (whether stock or mutual) are generally permitted to deduct dividends and similar distributions paid or declared to policyholders in their capacity as such. Stock companies may not, however, deduct dividends paid to shareholders. This distinction between policyholder and shareholder dividends also exists in the case of life insurance companies, but deductible policyholder dividends paid by mutual life insurance companies are reduced by an amount intended to reflect the portion of the distribution allocable to the companies' earnings and profits (as distinguished from the proportion that is a policyholder rebate).	The President's proposal would require the deduction for policyholder dividends of mutual property and casualty companies to be reduced in a manner similar to the reduction applicable to mutual life insurance companies. The proposal states that additional study is needed to determine the size of the competitive advantage that the current treatment of policyholder dividends provides to mutual property and casualty companies and to set the appropriate deduction limitation. *Effective date.*—The proposal would be effective for taxable years beginning after December 31, 1985.	Require the Secretary of the Treasury to submit to the Committee on Ways and Means, the Committee on Finance, and the Joint Committee on Taxation, a study of the treatment of policyholder dividends by mutual property and casualty insurance companies and whether any changes in such treatment would be appropriate. This study would be due not later than January 1, 1988.

Item	Present Law	President's Proposal	Possible Option
3. **Protection against loss account for mutual companies**	Mutual property and casualty insurance companies are permitted deductions for contributions (which are merely bookkeeping entries) to a protection against loss ("PAL") account. The amount of the deduction is equal to the sum of one percent of the underwriting losses for the year, plus 25 percent of statutory underwriting income, plus certain windstorm and other losses. The account is established for a 5-year period and, in effect, gives a 5-year deferral of a portion of mutual company underwriting income.	The President's proposal would repeal the deduction for contributions to a PAL account. Amounts currently held in the account would be included in income no later than ratably over a 5-year period. *Effective date.*—The proposal would be effective for taxable years beginning after December 31, 1985.	Same as the President's proposal.
4. **Special exemptions, rates, and deductions of small mutual companies**	Under present law, mutual property and casualty companies are classified into three categories depending upon the amounts of their gross receipts. Mutual companies with certain gross receipts not in excess of $150,000 are tax-exempt. Companies whose gross receipts exceed $150,000 but do not exceed $500,000 are "small mutuals" and may be taxed solely on investment income. Small mutuals which are subject to tax because their gross receipts exceed $150,000 may claim the benefit of a special rule which phases in the regular tax on investment income as gross receipts increase from $150,000 to $250,000. Companies whose gross receipts exceed $500,000 are ordinary mutuals taxed on both investment and underwriting income. Like stock companies, ordinary mutuals generally are subject to the regular corporate income tax rates. Mutuals whose taxable income does not exceed $12,000 pay a lower tax. No tax is imposed on the first $6,000 of taxable income, and a tax of 30 percent is imposed on the next $6,000 of taxable income. For small mutual companies which are taxable on investment income, no tax is imposed on the first $3,000 of taxable investment income, and a tax of 30 percent is imposed on taxable investment income between $3,000 and $6,000. Mutual companies that receive a gross amount from premiums and certain investment income of less than $1,100,000 are allowed a special deduction against their underwriting income (if it is subject to tax). The maximum amount of the deduction is $6,000, and the deduction phases out as the gross amount increases from $500,000 to $1,100,000.	The special tax exemptions, rate reductions, and deductions of small mutual property and casualty insurance companies would be repealed. *Effective date.*—The proposal would be phased in over a 5-year period starting with the first taxable year beginning after December 31, 1985.	Adopt a single small property and casualty company provision. *Effective date.*—The proposal would be effective for taxable years beginning after December 31, 1985.

Item	Present Law	President's Proposal	Possible Option
Treatment of Tax-Favored Savings **1. Individual retirement arrangements (IRAs)**			
a. Spousal IRA	An individual is permitted an additional deduction for contributions to an IRA for the benefit of the individual's spouse if (1) the spouse has no compensation for the year, (2) the spouse has not attained age 70½, and (3) the couple files a joint income tax return for the year. The annual deduction limit is increased from $2,000 to $2,250 (or 100 percent of compensation, if less). This contribution may be divided as the spouses choose, provided the contribution for neither spouse exceeds $2,000. If both spouses have any compensation, including compensation less than $250, the spousal IRA deduction is not allowed.	For purposes of calculating the spousal IRA deduction limit, all earned income of both spouses could be considered if the couple filed a joint return. Thus, deductible IRA contributions of up to $2,000 per year to each individual's IRA would be permitted for a couple filing a joint return provided their combined earned income was at least $4,000.	Retain the existing $2,250 limit on spousal IRAs, but permit the total earned income of a couple filing a joint return to be taken into account in applying the limit. Thus, a spouse with less than $250 of compensation will not be precluded from receiving spousal IRA contributions. See, also, the proposal relating to qualified cash or deferred arrangement, below.
b. Additional income tax on early withdrawals	Amounts withdrawn from an IRA prior to age 59½, death, or disability of the owner are subject to a ten-percent additional income tax.	The additional income tax on IRA withdrawals prior to age 59½, death, or disability generally would be increased from 10 to 20 percent. The 10-percent tax would continue to apply to distributions made on account of (1) acquisition of the participant's first personal residence, (2) the payment of college expenses of a dependent, or (3) unemployment during a period following the cessation of unemployment benefits. *Effective date.*—The provision would apply for taxable years beginning after December 31, 1985.	The additional income tax on IRA withdrawals prior to age 59½, death, or disability would be increased from 10 to 15 percent. The tax would be waived if the withdrawal is one of a scheduled series of level payments under an annuity for the life of the IRA owner (or the joint lives of the owner and the owner's beneficiary). *Effective date.*—Same as the President's proposal.
2. Qualified cash or deferred arrangements (sec. 401(k) plans)	If a cash or deferred arrangement meets certain requirements, an employee who has a choice of receiving current pay or having that pay deferred under a profit-sharing or stock bonus plan, can elect to defer compensation without being taxed as though the compensation had been received.	As modified, the President's proposal would repeal present law. *Effective date.*—The President's proposal would be effective for plan years beginning after December 31, 1985.	
a. Limit on elective deferrals	Elective deferrals under a qualified cash or deferred arrangement (CODA) are subject to the overall limits on annual additions under a defined contribution plan. Thus, under present law, the elective deferrals of any employee (plus employer contributions and certain other amounts) generally cannot exceed the lesser of $30,000 or 25 percent of the employee's nondeferred compensation.		Retain present law dollar limits on spousal IRA deductions. Limit the maximum annual elective deferral for an employee under all CODAs to $5,000. Limit the maximum elective deferral for an employee under a salary reduction tax-sheltered annuity to $5,000. Reduce the overall dollar limits on contributions and benefits under qualified plans to $25,000 for defined contribution plans and $75,000 for defined benefit pension plans. Provide that the limits will not be indexed for cost-of-living adjustments until 1991.

Item	Present Law	President's Proposal	Possible Option
b. Coordination with IRA contributions	Under present law, the limit on an employee's elective deferrals under a CODA is not coordinated with the limit on an employee's deductible IRA contributions.		Similar to the President's proposal of May 1985 (before modification), reduce an employee's IRA deduction limit, dollar for dollar, by the employee's elective deferrals under a CODA. Also provide for the reduction of the first $2,000 of the spousal IRA deduction limit.
c. Nondiscrimination requirements	A special nondiscrimination test applies a limit on elective deferrals under a CODA by the group of highly paid employees that is determined by reference to the rate of deferrals by other employees. An employee is considered highly paid, for this purpose, if the employee is one of the highest paid ⅓ of all employees. A CODA meets this special nondiscrimination test for a plan year if— (1) the average deferral percentage for the highly paid employees does not exceed the average deferral percentage for the other eligible employees by more than 150 percent, or (2) the average deferral percentage for the highly paid employees does not exceed the average deferral percentage of the other eligible employees by more than (a) 250 percent and (b) three percentage points.		Similar to the President's proposal of May 1985 (before modification), modify the special nondiscrimination tests applicable to qualified CODAS by redefining the group of highly compensated employees and by modifying the special percentage tests. *Highly compensated employees.*—Under the proposal, the following employees would be treated as highly compensated: (1) five percent owners; (2) the ten employees owning the largest interests in the employer who have compensation in excess of the limit on annual additions under a defined contribution plan ($30,000 for 1986); (3) employees earning more than $50,000; (4) the top ten percent of employees by pay, excluding (i) employees earning less than $20,000 and (ii) employees who earn less $35,000 and who are not among the top five percent by compensation; and (5) family members of the top ten employees by compensation, if such family members participate in the CODA. *Nondiscrimination test.*—Alter the special nondiscrimination test so that the average deferral by highly compensated employees may not exceed 125 percent of the average deferrals of all nonhighly compensated employees. If the special nondiscrimination test is not satisfied for any year, provide that the excess elective contributions by the highly compensated employees would be treated as nondeductible employer contributions. Excess elective deferrals would be required to be distributed by the end of the plan year following the plan year to which the deferral relates to avoid disqualification of the plan.

Item	Present Law	President's Proposal	Possible Option
d. Withdrawal and other restrictions	A participant in a qualified CODA is not permitted to withdraw elective deferrals (or earnings thereon) before age 59½, death, disability, separation from service, retirement, or the occurrence of a hardship. It is unclear under present law whether tax-exempt and public employers may establish a CODA.		Similar to the President's proposal of May 1985 (before modification), impose the following additional restrictions on CODAs: (1) hardship withdrawals would not be permitted under a CODA; (2) withdrawals on account of plan termination would be permitted; (3) an employer could not condition, either directly or indirectly (other than through matching contributions), contributions and benefits upon an employee's elective deferrals; (4) employees could not be required to complete more than one year of service to be eligible to defer; and (5) CODAs would not be available to employees of tax-exempt and public employers. *Effective date.*—The proposal would be effective for plan years beginning after December 31, 1985. For collectively bargained plans, the proposal would not be effective for plan years beginning before the expiration of the collective bargaining agreement.
3. Employer matching contributions and employee contributions			
a. Employer matching contributions	If an employer contribution under a qualified plan is conditioned on an employee's contribution, the employer matching contribution (adjusted, in an integrated plan, for certain social security benefits) must be a uniform percentage of compensation. An employer may elect to treat certain employer matching contributions to a CODA under the special nondiscrimination tests which permit higher contributions (as a percentage of compensation) for the top ⅓ of employees by compensation, but which do not permit social security benefits to be taken into account.	Under the proposal, two special nondiscrimination tests would be applied to employer matching contributions under any qualified plan. An aggregation rule would apply if employer matching contributions are tied to elective deferrals under a CODA. *Qualifying employer matching contributions.*—Qualifying employer matching contributions for any highly compensated employee would be limited to the greater of (1) 125 percent of the percentage of average matching contributions for nonhighly compensated employees or (2) the lesser of 200 percent of the percentage of average matching contributions for nonhighly compensated employees or the average percentage plus two percentage points.	*Qualifying employer matching contributions.*—The average qualifying employer matching contributions and voluntary employee contributions for highly compensated employees would be limited to 125 percent of the average of such contributions made for nonhighly compensated employees.

Item	Present Law	President's Proposal	Possible Option
a. Employer matching contributions —(Continued)		Qualifying employer matching contributions are required to be (1) nonforfeitable when made, (2) ineligible for withdrawal prior to the employee's death, disability, separation from service, or plan termination, and (3) no greater than 100 percent of the employees' mandatory contributions.	
		Other employer matching contributions.—Under the proposal, employer matching contributions that are not qualifying employer matching contributions for any highly compensated employee would be limited to the greater of (1) 110 percent of the percentage of average nonqualifying contributions for the nonhighly compensated employees, or (2) the lesser of 150 percent of the percentage of average nonqualifying contributions for nonhighly compensated employees or the average percentage plus one percentage point.	*Other employer matching contributions.*—The average of nonqualifying employer matching contributions for highly compensated employees would be limited to 110 percent of the average nonqualifying employer matching contributions for the nonhighly compensated employees.
		If the nonqualifying employer matching contributions are tied to elective contributions under a qualified cash or deferred arrangement, then this test would be applied by aggregating nonqualifying employer matching contributions and elective deferrals.	
b. Excess contributions	If employer matching contributions discriminate in favor of employees who are officers, shareholders or highly compensated, the plan is disqualified.	Under the President's proposal, (1) the employer would be denied a deduction for any contributions on behalf of highly compensated employees in excess of the amount permitted under the matching contribution rules, (2) those excess contributions would be subject to a nondeductible ten percent excise tax, and (3) unless the excess contributions (plus earnings thereon) were distributed by the end of the plan year following the year for which the contributions were made, the plan would be retroactively disqualified.	Generally the same as the President's proposal, modified in the following respects: (1) permit the employer to deduct the amount of certain excess contributions under the general deduction rules and (2) impose a tax equal to ten percent of the excess unless the excess contributions (plus earnings thereon) are distributed before the end of the year for which the contributions were made.
		Effective date.—The proposals would apply generally to plan years beginning after December 31, 1985. For collectively bargained plans, the proposals would apply to plan years beginning after the termination of the collective bargining agreement.	*Effective date.*—Same as the President's proposal.

Item	Present Law	President's Proposal	Possible Option
4. **Unfunded deferred compensation arrangements of State and local governments and tax-exempt employers**			
a. Eligible plan	Under an eligible deferred compensation plan maintained by a State or local government or rural electric cooperative, an employee may elect annual deferrals equal to the lesser of $7,500 or 33⅓ percent of compensation (net of the deferral). A participant in an eligible plan who elects to defer the receipt of current compensation will be taxed on the deferred amounts (and income attributable thereto) when such amounts are paid or otherwise made available. If an unfunded State or local plan (other than an eligible judicial plan) does not qualify as an eligible plan, the deferral is included in the employee's gross income when there is no longer a substantial risk of forfeiture of such amount.	The proposal would provide that the rules relating to eligible deferred compensation plans would apply to unfunded deferred compensation plans for employees of tax-exempt employers.	Same as the President's proposal.
b. Required distributions	Distributions under an eligible plan are required to commence no later than 60 days after the later of (1) the year in which the employee attains normal retirement age, or (2) the year in which the employee separates from service. The total benefits scheduled to be paid to the participant must be more than 50 percent of the maximum amount that could have been paid to the participant if no provision were made for payments to the beneficiary.	Under the proposal, distributions would be required (1) to satisfy a payout schedule under which benefits projected to be paid over the lifetime of the participant are at least 66⅔ percent of the total benefits payable with respect to the participant, (2) in the case of benefits payable over a period of more than one year, to be paid on a substantially nonincreasing basis, and (3) after the death of the employee, to provide for the commencement of benefits to the employee's beneficiary within one year after the employee's death. In addition, under the proposal, benefits would not be treated as made available merely because an employee is allowed to elect to receive a lump sum payable within 60 days of the election. This rule applies only if the employee's total deferred benefit does not exceed $3,500 and the employee is no longer entitled to elect deferrals under the plan. Certain tax-free rollovers between eligible plans would be permitted. *Effective date.*—The provisions would apply to taxable years beginning after December 31, 1985.	Same as the President's proposal.

Item	Present Law	President's Proposal	Possible Option
5. Deferred annuity contracts	Interest credited to the cash surrender value of a deferred annuity is not taxed currently, but is taxed when paid to the policyholder. If a policyholder receives any amount under an annuity contract before reaching age 59½, an additional income tax is imposed equal to five percent of the amount included in income. This penalty does not apply if the distribution is one of a series of periodic payments lasting at least 60 months or is made for certain other purposes.	The owner of a deferred annuity contract would include in income any increase in the excess of the contract's cash value over the owner's investment in the contract during the taxable year. The owner of a deferred variable annuity contract would be treated as owning a pro rata share of the assets and income of the separate account underlying the variable contract. As a result, the owner would not be taxed on the unrealized appreciation of assets underlying a variable contract. *Effective date.*—The proposal would become effective for investment income credited after December 31, 1985, to policies issued on or after the date of committee action.	Modify the President's proposal to allow investments by individual owners of up to $100,000 in deferred annuity contracts the income on which would not be taxable currently. In addition, the additional income tax on amounts withdrawn from deferred annuity contracts before age 59½ would be conformed to the 15-percent tax on early withdrawals from IRAs *Effective date.*—The proposal would be effective for amounts invested in deferred annuity contracts after September 25, 1985. However, the $100,000 cap on investments would be applied by taking into account investments made before the effective date.

Item	Present Law	President's Proposal	Possible Option
B. Minimum Standards for Qualified Plans			
1. Nondiscrimination rules			
a. Coverage requirements for qualified plans	The coverage rules for qualified plans require that a plan cover employees in general rather than merely employees who are officers, shareholders, or highly compensated. A plan generally satisfies the coverage rules if it meets either (1) a percentage test, or (2) a fair cross-section test.		
	Percentage test.—A plan meets the percentage test if (1) it benefits at least 70 percent of all employees, or (2) it benefits at least 80 percent of the employees eligible to benefit under the plan and at least 70 percent of all employees are eligible (i.e., the plan benefits at least 56 percent of all employees).	*Percentage test.*—The proposal provides that the coverage test would be met only if the percentage of highly compensated employees eligible to receive benefits does not exceed 125 percent of the percentage of all other employees receiving benefits. Under certain very limited circumstances in the case of a compelling business reason (such as a merger), the IRS could waive the 125 percent test in favor of a more liberal test for a period of time.	*Percentage test.*—A plan would meet the percentage test if the plan benefits at least 90 percent of all employees.
	Fair cross-section test.—A plan meets the fair cross-section test if the Secretary of the Treasury determines that it covers a classification of employees that is found not to discriminate in favor of employees who are officers, shareholders, or highly compensated.	*Fair cross-section test.*—Repeal present law.	*Fair cross-section test.*—Same as the President's propsal.
	Aggregation rules.—In applying both the percentage and fair cross-section tests, all employees of employers that are under common control are aggregated and treated as if employed by a single employer.	*Aggregation rules.*—Retain present law.	*Aggregation rules.*—An exception to the agregation rule would be provided in the case of an employer who, for bona fide business reasons, operates separate lines of business or operating units. Under this exception, an employer would be permitted to apply the percentage test separately to each line of business or operating unit. The exception would not be available unless— (1) each plan of the employer benefits at least 100 employees, and (2) no more than 25 percent of the participants in any plan are highly compensated employees.

Item	Present Law	President's Proposal	Possible Option
a. Coverage requirements for qualified plans (cont.)	*Highly compensated employees.*—Present law does not explicitly define the group of employees who are officers, shareholders, or highly compensated.	*Highly compensated employees.*—The proposal would provide a uniform definition of highly compensated employees. An employee would be treated as highly compensated for a plan year if, at any time during the three-year period ending on the last day of the plan year, the employee— (1) owns an interest of at least one percent of the employer (determined with attribution rules). (2) earns at least $50,000 in annual compensation from the employer; (3) earns at least $20,000 in compensation and is amoung (a) the top 10 percent of employees by compensation, or (b) the top three employees by compensation; or (4) is a family member of another highly compensated employee for such year. Certain mechanical adjustments would be made to the top ten-percent and three highest-paid employees tests to take into account an employer's salary structure. Similarly, adjustments would be provided to the three-year lookback rule to reflect significant fluctuations in an employer's workforce.	*Highly compensated employees.*—Treat the following employees as highly compensated for purposes of determining whether a qualified plan is nondiscriminatory: (1) five percent owners, (2) the ten employees owning the largest interests in the employer who have compensation in excess of the limit on annual additions under a defined contribution plan ($30,000 for 1986); (3) employees earning more than $50,000; (4) the top ten percent of employees by pay, excluding (i) employees earning less than $20,000 and (ii) employees who earn less than $35,000 and who are not among the top-five percent by compensation; and (5) family members, who are covered by the plan, of the top ten employees by compensation. An employee would be considered highly compensated if the employee (1) was highly compensated in either of the two plan years preceding the current plan year or (2) is one of the top 100 highly compensated employees by compensation for the current plan year.
	Excludable employees.—In applying the percentage test, certain employees who have not (1) completed minimum periods of service (generally one year), and (2) attained age 21 may be disregarded. Employees with less than three years of service may be excluded if the plan provides for full and immediate vesting. In addition, in applying both the percentage and the fair cross-section test, employees not covered by the plan who are included in a unit of employees covered by a collective bargaining agreement are disregarded if there is evidence that retirement benefits were the subject of good faith bargaining. Certain nonresident aliens and certain airline pilots also are disregarded.	*Excludable employees.*—The proposal would narrow the class of employees who could be excluded from consideration in applying the percentage test by repealing the exceptions for employees with less than three years of service and for certain airline pilots.	*Excludable employees.*—Follow the President's proposal, but continue the present-law exception for certain airline pilots and preclude application of the collective bargaining exception in the case of a non bona-fide collective bargaining agreement. Under the proposal, compensation taken into account in determining whether a qualified plan is nondiscriminatory would be limited to $200,000.
		Effective date.—The President's proposal would be effective for plan years beginning after December 31, 1986. For collectively bargained plans, the proposal would not apply to plan years beginning before the termination of the current collective bargaining agreement.	*Effective date.*—Same as the President's proposal.

Item	Present Law	President's Proposal	Possible Option
b. Nondiscrimination rules applicable to tax-sheltered annuities	Under present law, a qualified plan is required to meet requirements as to coverage and as to contributions and benefits provided under the plan, which ensure that the plan does not discriminate in favor of employees who are officers, shareholders, or highly compensated. A tax-sheltered annuity program maintained by a tax-exempt charitable organization or certain educational institutions is not required to meet these nondiscrimination requirements.	No provision.	The nondiscrimination rules applicable to qualified plans (as modified above), would be applied to tax-sheltered annuity programs maintained by certain tax-exempt organizations (other than churches). A conforming change would be provided to require salary reduction tax-sheltered annuity programs to meet the special nondiscrimination test applicable to a qualified cash or deferred arrangement. *Effective date.*—The proposal would be effective for plan years beginning after December 31, 1985.
c. Nondiscrimination rule for defined benefit plans	Under present law, a plan is not qualified unless contributions and benefits do not discriminate in favor of employees who are officers, shareholders, or highly compensated. A plan is not considered discriminatory merely because benefits provided under the plan bear a uniform relationship to compensation. For purposes of determining whether benefits bear a uniform relationship to compensation, the employer-provided share of an employee's social security benefit may be taken into account. Under certain circumstances, the employer-provided share of social security benefits may be taken into account more than once under a defined benefit pension plan because an employer may reduce plan benefits by social security benefits earned with a prior employer.	No provision.	Provide that social security benefits earned with a prior employer are not to be considered in testing whether a defined benefit pension plan is considered discriminatory. *Effective date.*—The proposal generally would be effective for plan years beginning after December 31, 1985.
d. Top-heavy plans	Under present law, the benefit accrual rules generally applicable to qualified defined benefit plans do not apply to the minimum benefits required under a top-heavy plan. The fractional benefit accrual rule provides that each participant's accrued benefit at the end of any year must be at least equal to an amount determined by dividing the participant's years of participation by the total number of years of participation to normal retirement age.	No provision.	A uniform benefit accrual rule would be applied in testing whether a qualified defined benefit plan is top heavy. In determining whether a plan is top heavy, the fractional benefit accrual rule would be applied. *Effective date.*—The proposal would be applied for plan years beginning after December 31, 1985.
2. Benefit forfeitures	Forfeitures in a money purchase pension plan may not be reallocated to remaining participants, but must be used to reduce future employer contributions or to offset plan administrative expenses.	The proposal would permit forfeitures to be reallocated to remaining participants. *Effective date.*—The proposal would apply to plan years ending after December 31, 1985.	Same as the President's proposal.

Item	Present Law	President's Proposal	Possible Option
Withdrawal of Benefits **1. Uniforn minimum distribution rules**	Tax-favored retirement arrangements are subject to certain minimum requirements concerning the timing and amount of before-death and after-death distributions. Under these rules, distribution of a participant's benefits must commence no later than April 1 of the calendar year following the calendar year in which the participant (1) attains age 70½ or (2) with respect to participants who are not 5-percent owners, the taxable year in which the participant retires, if later. Distributions from an IRA are required to commence no later than April 1 of the calendar year following the calendar year in which the owner attains age 70½. A qualified plan failing to satisfy the minimum distribution rules may be disqualified. A 50-percent excise tax applies to amounts required to be distributed from an IRA that are not distributed.	The proposal would retain the present law rules relating to benefit commencement date and would subject all qualified plans, tax-sheltered annuities and IRAs to uniform minimum distribution rules. Certain simplifying modifications would be made to those rules. Under the proposal, the uniform sanction for failure to satisfy the minimum distribution rules would be a nondeductible excise tax equal to 50 percent of the amount by which the minimum amount required to be distributed exceeds the amount actually distributed. The recipient of the distribution would be primarily liable with a right, where appropriate, to recover the tax from the plan. The current disqualification sanction would be eliminated. *Effective date.*—The proposal generally applies for distributions made after December 31, 1985.	Generally, the same as the President's proposal, except that a uniform benefit commencement date would apply to qualified plans, IRAs and tax-sheltered annuities. Distributions would be required to commence no later than April 1 of the calendar year following the calendar year in which the participant attains age 70½. *Effective date.*—Same as the President's proposal.
2. Withdrawals before age 59½ ***a. Additional income tax on early withdrawals***	A ten-percent additional income tax is imposed on certain early withdrawals from qualified plans with respect to five-percent owners who have not attained age 59½, unless the early withdrawal is made on account of the employee's disability or death. A similar tax also applies to early withdrawals made from an IRA.	*Affected participants.*—The proposal would conform the early withdrawal rules for qualified plans to the rules for IRAs. Thus, an additional income tax would apply to any participant in a qualified plan or tax-sheltered annuity who receives a distribution before age 59½, death or disability unless the distribution is made in the form of a qualifying annuity. *Qualifying annuity.*—A qualifying annuity would be an annuity commencing after the participant attains age 50, payable as one of a scheduled series of substantially nonincreasing payments under (1) an annuity for the life of the participant (or the joint lives of the participant and the participant's beneficiary), or (2) an annuity for a term certain of at least 180 months commencing upon retirement under the plan.	Generally the same as the President's proposal, subject to the following modifications: *Qualifying annuity.*—A qualifying annuity which is not subject to the additional income tax would be an annuity commencing at any age and payable in substantially level payments for the life of the participant (or the joint lives of the participant and the participant's beneficiary).

Item	Present Law	President's Proposal	Possible Option
a. Additional income tax on early withdrawals (cont.)		*Rate of tax.*—The rate of tax generally would be 20 percent of the amount includible in income. The tax would be reduced to ten percent if the distribution is made on account of (1) the purchase of the individual's first principal residence, (2) the payment of college expenses for a dependent of the individual, or (3) unemployment during the period following the cessation of unemployment benefits.	*Rate of tax.*—The rate of tax would be 15 percent of the amount includible in income.
b. Tax-sheltered annuities	Withdrawals under a tax-sheltered annuity invested in a custodial account may not commence prior to the time an employee attains age 59½, dies, becomes disabled, separates from service, or encounters financial hardship. Other tax-sheltered annuities are not subject to these withdrawal restrictions or the ten-percent additional income tax on early distributions.	The proposal would extend the withdrawal restrictions applicable to tax-sheltered annuities invested in a custodial account to all tax-sheltered annuities.	Same as the President's proposal.
		Effective date.—The provisions would apply for taxable years beginning after December 31, 1985. However, the early withdrawal restriction would not apply to annuities with respect to which no additional contributions were made after December 31, 1985.	*Effective date.*—Same as the President's proposal.
3. Uniform tax treatment of distributions			
a. Rollovers	Under certain circumstances, distributions from a qualified plan may be rolled over, tax-free, to another qualified plan or IRA. Special rules govern the extent to which distributions from particular plans may be rolled over, as well as the types of plans to which rollovers may be made. In general, these rules are designed to prevent individuals from avoiding restrictions or become entitled to additional tax benefits by shifting money between plans.	The proposal would permit all distributions (other than required minimum distributions) to be rolled over to other tax-favored retirement arrangements.	Retain present-law rollover restrictions.
b. 10-year forward income averaging	Certain lump sum distributions received under a qualified plan may qualify for special 10-year forward averaging treatment.	The proposal would repeal the special 10-year forward averaging treatment.	Generally the same as the President's proposal with respect to lump sum distributions before age 59½. With respect to lump sum distributions after age 59½, permit one lifetime election to claim averaging treatment with respect to a lump sum received from a qualified plan. Reduce the averaging period from 10 to 5 years.

Item	Present Law	President's Proposal	Possible Option
c. Pre-1974 capital gains treatment	A participant may elect to treat the pre-1974 portion of any lump sum distribution as long-term capital gains.	The proposal would repeal the special pre-1974 capital gains treatment.	Generally the same as the President's proposal, effective for distributions received after December 31, 1985.
d. Net unrealized appreciation	If an employee receives a lump sum distribution that includes employer securities, only an amount equal to the plan's basis in the securities is currently includible in income. Recognition of the net unrealized appreciation is deferred until the securities are sold or exchanged. In addition, to the extent any distribution consists of employer securities attributable to employee constributions, recognization of the net unrealized appreciation is deferred until the securities are sold or exchanged.	The proposal would repeal the provisions permitting deferred recognition of net unrealized appreciation.	Generally the same as the President's proposal, except that present law is retained with respect to securities attributable to employee contributions.
e. Constructive receipt	Under a tax-sheltered annuity, unlike a qualified plan, a participant is taxed when benefits are received or made available.	The proposal would tax participants under a tax-sheltered annuity only when benefits are received.	Same as the President's proposal.
f. Basis recovery	Distributions prior to the annuity starting date are treated as being made first out of nontaxable employee contributions and then out of taxable amounts (employer contributions and income). Distributions after the annuity starting date are treated under the following rules: (1) In general, each payment is treated as part a payment of income and part a recovery of employee contributions. (2) Under a special rule, if an individual will receive all employee contributions within the first three years after the annuity starting date, then all distributions are considered a return of employee contributions until the individual's basis has been recovered.	With respect to distributions before the annuity starting date, the proposal would reverse the ordering rules—treating the distributions as being made first out of taxable amounts (employer contributions plus interest) and then out of nontaxable employee contributions. The proposal would repeal the special 3-year basis recovery rule and treat each distribution as part of a payment of income and part as recovery of employee contributions, under modified basis recovery rules.	Same as the President's proposal.

Item	Present Law	President's Proposal	Possible Option
f. Basis recovery (cont.)		*Effective dates.*—The provisions generally would apply to distributions made after December 31, 1985. However, the repeal of capital gain, 10-year forward averaging, and net unrealized appreciation would be phased in over a 6-year period for individuals who will have attained age 55 before January 1, 1987. During the transition period, 10-year forward averaging calculations would use the present-law rate schedules. In addition, the basis recovery rules applicable to distributions made before the annuity starting date would not apply to benefits accrued prior to January 1, 1986. The repeal of the 3-year basis recovery rule and the modification of the exclusion ratio would not apply to any amount received as an annuity if the annuity was in pay status on January 1, 1986.	*Effective dates.*—Generally the same as the President's proposal, except that no transition rule would be provided with respect to the reordering of the basis recovery rules applicable to distributions before the annuity starting date. In addition, present law would continue to apply to net unrealized appreciation attributable to securities held as of December 31, 1985.
4. Loans under qualified plans			
a. Amounts treated as distributions	Subject to certain exceptions, a loan to a participant from a qualified plan is treated as a taxable distribution of plan benefits. An exception is provided to the extent that the loan, when added to the outstanding balance of all other plan loans, does not exceed the lesser of (1) $50,000, or (2) the greater of $10,000 or one-half the participant's accrued benefit.	Under the proposal, a loan would be treated as a distribution to the extent that the loan (when added to any outstanding balance) exceeds the lesser of (1) $50,000, reduced by the highest outstanding loan balance during the prior 12 months, or (2) the greater of $10,000 or one-half of the employee's accrued benefit.	Same as the President's proposal.
b. Repayment period	The exception applies only if the loan must, by its terms, be repaid within five years, or within a reasonable period if the loan is used to acquire or improve a personal residence of the participant or family member.	The proposal provides an exception to the five-year repayment period only for those loans applied to the first-time purchase of the participant's principal residence.	In addition to the President's proposal, require level amortization of a loan over the permissible repayment period.
c. Interest paid on plan loans	Interest paid on a loan from a qualified plan is deductible.	No provision. *Effective dates.*—The provisions would be effective for amounts received as a loan after December 31, 1985.	Defer the deduction for interest paid by (1) all employees with respect to loans secured by elective deferrals under a qualified cash or deferred arrangement or tax-sheltered annuity, and (2) key employees with respect to loans from any qualified plan, by denying a deduction for the interest and increasing a participant's basis under the plan by the amount of nondeductible interest paid. *Effective date.*—The modification would be effective for amounts received as a loan after December 31, 1985.

Item	Present Law	President's Proposal	Possible Option
). Tax Deferral Under Qualified Plans			
1. Overall limits on contributions and benefits			
a. Defined contribution plans	Annual additions on behalf of a participant under a qualified defined contribution plan are limited to the lesser of (i) 25 percent of compensation, or (ii) $30,000. Annual additions include employer contributions, forfeitures, and if employee contributions exceed six percent of compensation, the lesser of (i) one-half the employee contributions, or (ii) total employee contributions in excess of six percent of compensation.	One-half of all employee contributions would be treated as annual additions.	Treat all employee contributions as annual additions.
b. Defined benefit plans	Annual benefits payable on behalf of a participant from a qualified defined benefit plan are limited to the lesser of (i) 100 percent of compensation or (ii) $90,000. This limit is proportionately reduced for participants with less than ten years of service.	The overall limit would be reduced for participants with less than ten years of plan participation.	Same as the President's proposal.
c. Combined plan limit	The combined plan limit for an individual who participates in both a defined contribution plan and a defined benefit plan of the same employer is equal to the lesser of (i) 125 percent of the separate plan dollar limits, or (ii) 140 percent of the separate plan percentage limits. A lower combined plan limit applies for individuals participating in a top-heavy plan. The limit is the lesser of (i) 100 percent of the otherwise applicable separate plan dollar limits, or (ii) 140 percent of the otherwise applicable separate plan percentage limits. In the case of a plan that is not super top-heavy, the lower combined plan limit does not apply if certain requirements are met.	The combined plan limit for individuals who participate in both a defined contribution plan and a defined benefit plan of the same employer would be repealed for all nontop-heavy plans. An additional excise tax would be imposed on all participants receiving annual benefits in excess of a specified amount. To the extent that aggregate annual distributions made with respect to any individual from qualified plans, IRAs, and tax-sheltered annuities exceed that dollar amount, an excise tax equal to ten percent of the excess would be imposed. Under the proposal, the dollar amount would be 1.25 times the defined benefit dollar limit (e.g., 1.25 times $90,000 would equal $112,500 for 1985 through 1987).	Retain the combined plan limit. Apply a 15-percent excise tax, rather than a 10-percent tax on aggregate annual distributions from all tax-favored retirement arrangements in excess of 1.25 times the defined benefit plan dollar amount (i.e., 1.25 times $90,000, or $112,500, under the proposal).

Item	Present Law	President's Proposal	Possible Option
1. Overall limits on contributions and benefits (cont.)			
d. Tax-sheltered annuities	In the case of a tax-sheltered annuity, special one-time elections increase the overall defined contribution plan limit. The special elections allow certain catch-up contributions in a year, to the extent permitted by the section 403(b) exclusion allowance. An additional election permits a church employee to elect to increase the overall limit by up to $10,000 for any year, not to exceed a lifetime amount of $40,000 for any employee.	The special catch-up elections would be repealed. *Effective date.*—The modifications to the overall limits would generally apply to limitation years beginning after December 31, 1985. For collectively bargained plans, the modifications would apply to limitation years beginning after termination of the collective bargaining agreement. The ten percent recapture tax would apply to distributions made after December 31, 1985, in taxable years of the recipients beginning after such date. The provision phasing in the requirement that the defined benefit dollar limit be reduced for participants with less than ten years of participation would be phased in, becoming fully effective for years beginning after December 31, 1993.	Same as the President's proposal. *Effective date.*—Same as the President's proposal.
2. Deductions for contributions to qualified plans			
a. Profit-sharing and stock bonus plans	Employer contributions for a year not in excess of 15 percent of the aggregate compensation of covered employees are generally deductible for the year paid. Employer contributions in excess of the deduction limits may be carried over and deducted in later years. If the contribution for a particular year is lower than the deduction limit, the unused limit may be carried over and used in later years.	The proposal would modify the 15 percent of compensation limit to apply on an individual, rather than an aggregate, basis. Thus, the deductible contribution with respect to a particular employee could not exceed 15 percent of that employee's compensation. The present-law carryforward for unused deduction limits would be repealed except under certain "retirement type" profit-sharing plans. A profit-sharing plan would be treated as a "retirement type" plan with respect to an individual if: (1) the individual is an active participant in the plan; (2) the individual is not a participant in any other profit-sharing or stock-bonus plan maintained by the employer; (3) contributions are based on a formula using a reasonable year-of-service factor; (4) certain benefits are not available before separation from service, death, or disability; and (5) the plan is not top-heavy.	Maintain the 15-percent of aggregate compensation deduction limit. In the case of a profit-sharing or stock bonus plan integrated with social security, reduce this limit by the employer share of social security taxes taken into account under the plan. Repeal the limit carryforward for all profit-sharing and stock bonus plans (including retirement-type plans).

Item	Present Law	President's Proposal	Possible Option
b. Defined benefit plans	Employer contributions under a defined benefit pension plan are required to meet a minimum funding standard. In calculating the minimum funding requirement and deduction limits, employers are required to use actuarial assumptions that are reasonable in the aggregate.	No proposal.	Require that certain actuarial assumptions that have a material effect on the measurement of liabilities (e.g., interest rate and maritial status) be reasonable, standing alone.
c. Combination of pension and other plan	Employer contributions to a money purchase pension plan are generally deductible under rules applying to pension plans. The amount required under the minimum funding standard is the contribution rate specified by the plan, which cannot exceed 25 percent of a participant's compensation. If an employer maintains a pension plan (defined benefit or money purchase) and either a profit-sharing or stock bonus plan for the same employee, then the employer's deduction for contributions for that year is generally limited to the greater of (i) the amount needed to satisfy the minimum funding requirements of the pension plan or (ii) 25 percent of the aggregate compensation of covered employees. This limit does not apply when an employee participates in both a defined benefit and a money purchase pension plan of the same employer.	The proposal would extend the 25-percent of aggregate compensation limit to all combinations of defined benefit and money purchase pension plans.	Same as the President's proposal.
d. Nondeductible contributions	Employer contributions in excess of the deduction limit may be carried over and deducted in later years.	Employer contributions in excess of the deductible limits would be subject to a ten percent annual nondeductible excise tax until the excess is eliminated. *Effective date.*—The proposals generally would be effective for years beginning after December 31, 1985. Special transition rules would maintain certain limit carryforwards and permit the deduction of excess contributions carried forward from years before the effective date.	Generally the same as the President's proposal, except that the tax would be imposed at a 15-percent rate. *Effective date.*—Generally the same as the President's proposal except that the provision relating to actuarial assumptions would apply only to taxable years beginning after the issuance of Treasury regulations.
3. Asset reversions under qualified plans	Prior to the satisfaction of all liabilities with respect to employees and beneficiaries, assets held under a qualified plan generally may not be used for, or diverted to, purposes other than the exclusive benefit of employees. However, assets remaining in the plan upon plan termination generally may be paid to the employer after plan benefits, accrued to the date of the plan termination, have been provided. Assets reverted to the employer are includible in the employer's gross income.	To recapture a portion of the tax benefits of deferral of tax on earnings on previously deducted plan contributions, the proposal would impose a nondeductible excise tax equal to 10 percent of the plan funds reverting to the employer upon plan termination. *Effective date.*—The 10-percent recapture tax would apply to qualified plan assets reverting to an employer pursuant to a plan termination occurring after December 31, 1985.	Generally the same as the President's proposal, except that the recapture tax would be increased to 15 percent to conform to other proposed qualified plan recapture taxes. *Effective date.*—Same as the President's proposal.

Item	Present Law	President's Proposal	Possible Option
Fringe Benefits **1. Statutory fringe benefit exclusions**	Present law provides specific income tax and employment tax exclusions with respect to the following benefits provided by an employer to employees: (a) the cost of up to $50,000 of group-term life insurance; (b) up to $50,000 of death benefits; (c) accident or health benefits; (d) benefits under prepaid legal services plans; (e) commuting through use of a van pool; (f) up to $50,000 annually of employee educational assistance; and (g) dependent care assistance. The exclusions for prepaid legal services, van pooling, and employee educational assistance are scheduled to expire after 1985.	The President's proposal would make several changes in the tax treatment of employer-provided fringe benefits.	
		Employer-provided health benefits.—Under the President's proposal, employer contributions on behalf of an employee to a health plan would be partially includible in the employee's gross income. The amount included in income would be $10 a month for individual coverage and $25 a month for family coverage.	*Employer-provided health benefits.*—The proposal would impose a cap on the value of employer-provided health benefits that would be excluded annually for income and employment tax purposes. The cap would be $120 per month for individual coverage and $300 per month for family coverage. Rules would be provided for purposes of determining the value of employer-provided health benefits, including the value of benefits provided under self-insured plans and multiemployer plans.
		Repeal of exclusion for employer-provided death benefits.—The President's proposal would repeal the $5,000 exclusion for employer-provided death benefits.	*Repeal of fringe benefit exclusions.*—The proposal would repeal the exclusions for the cost of up to $50,000 of group-term life insurance and up to $5,000 of death benefits. The proposal would clarify that the exclusion for the proceeds of life insurance provided by an employer are available only for life insurance contracts provided by a commercial insurance company.
		Expiration of van pooling exclusion.—The proposal would allow the exclusion for employer-provided transportation (van pooling) to expire on December 31, 1985, as scheduled under present law.	*Van pooling.*—Same as President's proposal.
		Employee educational assistance and group legal services.—Under the President's proposal, the exclusion for employee educational assistance and group legal services would be made permanent. The exclusion for a group legal services plan would be available only to the extent that employer contributions to the plan are fixed before the beginning of the year for which benefits are provided. Also, the annual cap on the educational assistance exclusion of $5,000 during a year for an employee would be repealed.	*Employee educational assistance and group legal services.*—The proposal would permit the exclusions for employee educational assistance and prepaid legal services to expire after 1985, as scheduled under present law. The proposal would clarify the circumstances under which educational expenses would be treated as job-related expenses, which would be deductible.
		Effective date.—The proposal generally would be effective for taxable years beginning after 1985.	*Effective date.*—The proposal generally would be effective for taxable years beginning after 1985.

Item	Present Law	President's Proposal	Possible Option
2. Nondiscrimination requirements	*In general.*—Under present law, exclusions for most of the statutory fringe benefits are conditions on compliance with various rules prohibiting discrimination in favor of employees who are officers, owners, or highly compensated. There is no nondiscrimination rule for benefits provided by an employer under an insured health plan or for the exclusion of up to $5,000 of death benefits paid by an employer. These nondiscrimination rules generally prohibit discrimination as to eligibility to participate. A plan or program is required to meet the eligibility requirement by covering a reasonable classification of employees in a manner determined by the IRS not to result in prohibited discrimination. A self-insured medical reimbursement plan or group-term life insurance plan may also satisfy the requirement by covering a stated percentage of the employer's employees. *Aggregation rules.*—In applying the nondiscrimination tests to certain statutory fringe benefits, all employees of employers that are under common control are aggregated and treated as if employed by a single employer. *Highly compensated employees.*—Present law does not explicitly define the group of employees who are officers, shareholders, or highly compensated. *Excludable employees.*—Employees who are covered by a collective bargaining agreement are generally excluded from consideration in applying the nondiscrimination rules as long as the benefits provided by the plan or program are the subject of good faith bargaining. The eligibility rules for self-insured medical reimbursement plans also provide that employees need not be taken into account if they have not completed three years of service, have not attained age 25, or are part-time or seasonal employees.	*In general.*—The President's proposal would establish uniform nondiscrimination rules applicable to employer-provided group-term life insurance, accident and health plans (whether or not insured), group legal services, employee educational assistance, dependent care assistance, cafeteria plans, miscellaneous fringe benefits, qualified tuition reductions, and welfare benefit funds. *Nondiscriminatory coverage.*—The proposal provides that the exclusion from gross income would be available only if the percentage of highly compensated employees eligible to receive benefits does not exceed 125 percent of the percentage of all other employees receiving benefits. Under certain very limited circumstances in the case of a compelling business reason (such as a merger), the IRS could waive the 125 percent test in favor of a more liberal test for a period of time. *Nondiscriminatory availability.*—Under the President's proposal, all types and levels of benefits available to any highly compensated participant must also be available to all nonhighly compensated participants. Similarly, any condition for receipt of a benefit would be required to be applied in a nondiscriminatory manner. *Insurance-type benefits.*—The proposal would apply a nondiscriminatory benefits test to group-term life insurance, health benefits, and group legal services benefits provided under a permanent and enforceable plan. This test would apply whether or not the benefit was provided through insurance or self-insured by an employer. Certain benefits would be permitted to vary by compensation level. *Noninsurance-type benefits.*—Under the proposal, employee educational assistance benefits, dependent care assistance, miscellaneous fringe benefits, and qualified tuition reductions would also be subject to a nondiscriminatory benefits test under which the average amount of benefits provided to highly compensated employees could not exceed 125 percent of the average amount of benefits provided to other employees. In the case of educational assistance benefits, only amounts expended for degree programs would be required to be tested under this nondiscrimination rule.	*In general.*—A fringe benefit plan, cafeteria plan, or welfare benefit fund would meet the nondiscrimination test if at least 90 percent of all employees are eligible to benefit under the plan. If more than 25 percent of the employees benefiting under a plan are highly compensated and the plan requires employee contributions as a condition of plan participation, then the plan would be considered nondiscriminatory if the employer demonstrates to the satisfaction of the Secretary of the Treasury that— (1) the contributions required by employees are not so burdensome as to result in discrimination in operation, or (2) that the plan, when combined with another comparable plan of the employer, is nondiscriminatory. *Comparable plan.*—If the employees' share of the costs of benefits are the same in each plan, then the average employer cost per employee covered by a plan could be used to test whether plans are comparable. The average employer cost per employee would be considered comparable if the average cost in any plan being tested for comparability is at least 80 percent of the average cost in any other plan in which more than 25 percent of the participants are highly compensated. *Aggregation rule.*—For purposes of applying the nondiscrimination test, generally all employees of all employers under common control would be treated as employed by a single employer. An exception to this aggregation rule would be provided in the case of an employer who, for bona fide business reasons, operates separate lines of business or operating units. Under this exception, an employer would be permitted to apply the nondiscrimination test separately to each line of business or operating unit. The exception would not be available unless each plan benefits at least 100 employees.

Item	Present Law	President's Proposal	Possible Option
2. Nondiscrimination requirements (cont.)	*Concentration test.*—An exclusion is not available unless the following concentration tests are satisfied: (1) in the case of dependent care assistance or prepaid legal services, no more than 25 percent of the amounts contributed for a plan year are provided to five-percent owners (or their spouses or dependents); or (2) in the case of employee educational assistance, no more than five percent of the amounts paid or incurred by the employer during a plan year are provided to five-percent owners (or their spouses or dependents).	*Concentration test.*—The President's proposal would modify the utilization test of present law applicable to group legal services, employee educational assistance, and dependent care assistance. Under the modification, the contributions provided to the top 20 highly compensated employees by compensation could not exceed 25 percent of the total contributions provided under the plan for any year. This rule would apply to each fringe benefit otherwise excludable from gross income.	
		Highly compensated employees.—the proposal would provide a uniform definition of highly compensated employees. An employee would be treated as highly compensated for a plan year if, at any time during the three-year period ending on the last day of the plan year, the employee— (1) owns an interest of at least one percent of the employer (determined with attribution rules); (2) earns at least $50,000 in annual compensation from the employer; (3) earns at least $20,000 in compensation from the employer and is among (a) the top ten percent of employees by compensation, or (b) the top three employees by compensation; or (4) is a family member of another highly compensated employee for such year. Certain mechanical adjustments would be made to the top ten-percent and three highest-paid employees tests to take into account an employer's salary structure. Similarly, adjustments would be provided to the three-year look-back rule to reflect significant fluctuations in an employer's workforce.	*Highly compensated employees.*—The following employees would be treated as highly compensated: (1) five percent owners; (2) the ten employees owning the largest interests in the employer who have compensation in excess of the limit on annual additions under a defined contribution plan ($30,000 for 1986); (3) employees earning more than $50,000; (4) the top-ten percent of employees by pay, excluding (i) employees earning less than $20,000 and (ii) employees who earn less than $35,000 and who are not among the top-five percent by compensation; and (5) family members, who are covered by the plan, of the top-ten highly compensated employees by compensation. An employee would be considered highly compensated if the employee (1) was highly compensated in either of the two plan years preceding the current plan year or (2) is one of the top 100 highly compensated employees by compensation for the current plan year.
		Excludable employees.—Certain classes of employees would be disregarded in applying the 125-percent test. Thus, under the proposal, the following employees need not be taken into account in testing whether a plan provides nondiscriminatory coverage: (1) if the plan so provides, employees with less than one year of service (30 or 90 days, in the case of an employer-maintained health plan), (2) if the plan so provides, part-time and seasonal employees, (3) employees covered by certain collective bargaining agreements, and (4) nonresident aliens who have no U.S. earned income.	*Excludable employees.*—Follow the President's proposal, but preclude application of the collective bargaining exception unless there is a bona-fide collective bargaining agreement. An employee would not be considered a part-time employee if the employee normally works at least 20 hours per week. In addition, the proposal would provide that the maximum length of service an employee could be required to complete before becoming eligible for plan participation would be 90 days.

Item	Present Law	President's Proposal	Possible Option
2. Nondiscrimination requirements (cont.)		*Sanctions for discrimination.*—Under the President's proposal, if a plan is found to be discriminatory in coverage, benefits, or utilization, the benefits provided to highly compensated employees would not be eligible for exclusion from gross income. The amount to be included in gross income in the case of insurance-type benefits would be the value of the coverage provided to a highly compensated employee and not reimbursements received under the plan for expenses. *Welfare benefit plans.*—The nondiscrimination rules of the President's proposal would also apply to benefits provided under a tax-exempt voluntary employees' beneficiary association, supplemental unemployment compensation benefit trust, or group legal services organizations. *Effective date.*—The Administration proposal relating to uniform nondiscrimination rules generally would be effective for plan years beginning after December 31, 1985, except that, in the case of a health plan, the proposal would be effective for plan years beginning after December 31, 1986. The proposal would provide a delayed effective date for collectively bargained plans.	*Effective date.*—Same as the President's proposal.
3. Benefits provided under a cafeteria plan	Under a cafeteria plan, an employee is offered a choice between cash and one or more fringe benefits. If certain requirements are met, then the mere availability of cash or certain permitted taxable benefits under a cafeteria plan does not cause an employee to be treated as having received the available cash or taxable benefits for income tax purposes. A highly compensated employee is treated as having received available cash and taxable benefits if the cafeteria plan discriminates in favor of highly compensated individuals as to eligibility or as to benefits and contributions. In addition, if more than 25 percent of the total excludable benefits for a plan year are provided to employees who are key employees (certain officers and owners), then the key employees will be taxed as though they received all available taxable benefits under the plan.	The President's proposal would apply a special rule to reimbursements of medical, legal, or dependent care expenses under a reimbursement account, under which the reimbursements would be deemed to be nondiscriminatory if the average reimbursements for highly compensated employees does not exceed 125 percent of the average reimbursements for all other participants in the cafeteria plan. In addition, the contributions provided to the top 20 highly compensated employees could not exceed 25 percent of the total contributions under the plan for any year. Under the proposal, reimbursement of insurance premiums would not be permitted from a reimbursement account. *Effective date.*—The President's proposal would be effective for plan years beginning after December 31, 1985.	Retain present law, but clarify that full-time life insurance salesmen may elect benefits under a cafeteria plan that they are otherwise permitted to exclude from income. *Effective date.*—The proposal would be effective for taxable years beginning after December 31, 1985.

Item	Present Law	President's Proposal	Possible Option
Income of a Minor Child **1. Unearned income of a minor child**	If income-producing assets are transferred to a minor child, income earned on those assets generally is taxed to the child at the child's marginal rate.	The proposal would tax unearned income of a child under 14 years of age to the child at the top marginal rate of the parents to the extent the income was attributable to property received from the parents. Earned income and unearned income derived from assets received from sources other than a parent that are placed in a qualified segregated account would be taxed at the child's marginal rate. Property eligible to be placed in a qualified segregated account would include earned income, money or property received from someone other than the parents and property received by reason of a parent's death. The proposal applies with respect to a child under 14 years of age who is eligible to be claimed as a dependent on the parents' return.	Special rules would be provided with respect to any child eligible to be claimed as a dependent on the parents' return, regardless of age. If the child's total unearned income is greater than $3,000, tax all unearned income in excess of the sum of $3,000 plus any allowable personal exemption to the child at the top marginal rate of the parents. If the child's unearned income is $3,000 or less, tax all unearned income in excess of the allowable personal exemption to the child at the child's marginal rates. Tax any earned income in excess of the allowable personal exemption and zero bracket amount to the child at the child's marginal rates.
2. Personal exemption and zero bracket amount	With respect to eligible minor children, both the child and the parents may claim a personal exemption ($1,040 for 1985). If a child is eligible to be claimed as a dependent on the parent's return, the child may apply the zero bracket amount ($2,390 for a single person for 1985) only against earned income.	Both the child and the parent may claim the increased personal exemption ($2,000). A child eligible to be claimed as a dependent on the parents return may use the zero bracket amount (under the proposal, $2,900 for a single individual) against earned income and against unearned income derived from assets held in a qualified segregated account. *Effective date.*—The proposal would apply for taxable years beginning after December 31, 1985.	The personal exemption allowed on the child's return would be limited to the lesser of (1) $100 plus any earned income or (2) $1,000. If the child has any earned income, the personal exemption must be applied first against earned income. In addition, to the extent the child's earned income exceeds the allowable personal exemption, the zero bracket amount may be used against earned income. *Effective date.*—Same as the President's proposal.

Item	Present Law	President's Proposal	Possible Option
. Income Taxation of Trusts and Estates			
1. In general	The income taxation of a trust depends on whether the trust is a grantor or nongrantor trust. In the case of a grantor trust (i.e., one where the grantor (or other person with the power to revoke the trust) has certain powers with respect to the trust), income is taxed directly to the grantor. In the case of a nongrantor trust, each trust is treated as a separate taxable entity.	As under present law, income of a grantor trust is taxed directly to the grantor. However, the President's proposal revises the definition of a grantor trust. During the lifetime of the grantor, all income of any nongrantor trusts generally would be taxed to the trust at the top marginal rate of the grantor.	The proposal also limits the scope of the grantor trust rules and continues to tax the income of a grantor trust directly to the grantor. Nongrantor trusts generally would be taxed at the top marginal rate of the grantor. In addition, special rules may permit the use of lower rates where the trust's beneficiaries are minor children of the grantor. In addition, in the case of a qualifying beneficiary trust, income generally would be taxed to the trust at the top marginal rate of the beneficiary. Foreign trusts would be taxed under the present law rules.
2. Trusts other than grantor trusts	Any trust that is not a grantor trust is treated as a separate taxable entity. *Taxable year.*—The trust may elect a taxable year other than that of the grantor. *Applicable rate.*—Each nongrantor trust separately calculates tax liability at the rate applicable to individual taxpayers.	Any trust that is not a grantor trust would continue to be treated as a separate taxable entity. *Taxable year.*—Each nongrantor trust would be required to adopt the same taxable year as the grantor. *Applicable rate.*—Each nongrantor trust generally is taxed at the top marginal rate of the grantor.	Same as the President's proposal. *Taxable year.*—Same as the President's proposal. *Applicable rate.*—Under the proposal, the income of a nongrantor trust that is not a qualified beneficiary trust generally would be taxed at the top marginal rate of the grantor. Unlike the President's proposal, the rate would be determined by applying any unused rate bracket amount allocated to the trust by the grantor. For example, if the grantor has $20,000 of unused rate bracket amount in the 25% bracket in a particular year, the grantor could allocate that amount to any trust he had created. The trust would be taxed at 25% on the first $20,000 of income and 35% on any income in excess of $20,000.

Item	Present Law	President's Proposal	Possible Option
2. Trusts other than grantor trusts (Cont.)			In addition, where the trust beneficiaries are children of the grantor who have not yet attained age 21, the unused rate bracket amounts of the children could be allocated to the trust. If no unused rate bracket amounts are allocated to a trust for a particular year, the income of the trust would be taxed at the top marginal rate (35%). *Qualified beneficiary trust.*—In the case of a qualified beneficiary trust, the income of the trust would be taxed at rates determined by using the unused rate bracket amount of the beneficiary. A qualified beneficiary trust is one where all of the trust income and corpus may be used only for distributions to, or for the benefit of, the beneficiary or his estate. A qualified beneficiary trust also includes any QTIP trust. Where a trust has more than one grantor, each portion of the trust attributable to a particular grantor generally would be treated as a separate trust for Federal tax purposes. However, married individuals could elect to be treated as a single grantor.
	Calculation of tax liability.—In calculating tax liability— (1) the personal exemption is limited to $100 or $300; (2) no zero bracket amount is permitted; (3) an unlimited charitable deduction is available; and (4) a distribution deduction generally is allowed for distributions to beneficiaries.	*Calculation of tax liability.*—In calculating tax liability, the President's proposal generally follows present law except that— (1) no personal exemption is allowed, and (2) a distribution deduction is allowed during the lifetime of the grantor only for certain mandatory distributions and only if the grantor has not retained a disqualifying interest. *Mandatory distributions.*—Mandatory distributions generally include— (1) A fixed or ascertainable amount of trust income or property required by the terms of the trust to be distributed to a specific beneficiary or beneficiaries (whether or not actually distributed); and	*Calculation of tax liability.*—In calculating tax liability, the proposal generally follows the President's proposal except that— (1) a personal exemption of $100 is allowed, and (2) a distribution deduction is not allowed at any time.

Item	Present Law	President's Proposal	Possible Option
2. Trusts other than grantor trusts (Cont.)		(2) Amounts irrevocably set aside for a beneficiary, provided the amount set aside is required to be distributed ultimately to the beneficiary or the beneficiary's estate, and the beneficiary agrees to include currently in income the amount set aside. *Disqualifying interest.*—If the grantor retains a disqualifying interest, then no distribution deduction will be permitted, even for mandatory distributions. A grantor has a disqualifying interest— (1) if any person other than the grantor or the grantor's spouse possesses the discretionary power to make payments of trust property to the grantor or the grantor's spouse; (2) if any portion of the trust may revert to the grantor or the grantor's spouse, unless the reversion cannot occur prior to the death of the income beneficiary of such portion and such beneficiary is younger than the grantor, or prior to the expiration of a term of years that is greater than the life expectancy of the grantor at the creation of the funding of the trust; (3) if any person has the power exercisable in a nonfiduciary capacity to control trust investments, to deal with the trust for less than full and adequate consideration, or to exercise any general administrative powers in a nonfiduciary capacity without the consent of a fiduciary; (4) if, and to the extent that, an otherwise deductible mandatory distribution satisfies a legal obligation of the grantor or grantor's spouse, including a legal obligation of support or maintenance; or (5) if trust income or corpus can be used to carry premiums on life insurance policies on the life of the grantor or the grantor's spouse with respect to which the grantor or the grantor's spouse possesses any incident of ownership.	

Item	Present Law	President's Proposal	Possible Option
2. Trusts other than grantor trusts (Cont.)	*Aggregation of trusts.*—Pursuant to Treasury regulations, two or more trusts will be treated as a single trust if (1) the trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (2) a principal purpose of the use of separate trusts is the avoidance of Federal income tax.	*Aggregation of trusts.*—Under the proposal, during the lifetime of the grantor, income of all trusts created by the grantor (in the case of a joint return, the grantor and the grantor's spouse) generally will be aggregated with the grantor's income (in the case of a joint return, the sum of the grantor's and the spouse's income) to determine the marginal tax rate applicable to the trust. The total tax then must be allocated to each trust proportionately on the basis of taxable income.	*Aggregation of trusts.*—Same as the President's proposal, except that it simplifies the aggregation by permitting the grantor (or designated beneficiary) to allocate unused rate bracket amounts. In addition, where trust beneficiaries are minor children of the grantor, it permits the children to allocate their unused rate bracket amounts to the trust, effectively subjecting some or all of the trust income to an effective tax rate lower than that of the grantor.
3. Taxation of trusts after the death of the grantor	Under present law, there is no distinction between the taxation of a trust during the grantor's lifetime or after his death.	For all taxable years beginning after the grantor's death, each trust established by the grantor must compute separately taxable income. Tax liability is computed using the rate schedule applicable to married individuals filing separately; with no zero bracket amount, no personal exemption and a deduction for all distributions actually made.	After the death of the grantor, the trust would determine its tax by taking into account any rate bracket amount allocated to the trust under the grantor's will. If the grantor's will does not provide for an allocation of his rate bracket amounts, his rate bracket amounts would be allocated among all the trusts created by the grantor in proportion to their values for estate tax purposes.
4. Taxation of distributions to beneficiaries	*In general.*—Distributions to beneficiaries are taxed to beneficiaries and deductible by the trust to the extent of the distributable net income (DNI) of the trust. *Tier System.*—DNI is allocated first to distributions that are required to be made out of income for the year, secondly to distributions made to charity out of trust income, and lastly to other distributions.	As under current law, distributions to beneficiaries that are deductible to the trust would be taxable to beneficiaries. However, the tier rules would be repealed and each recipient would take into account a proportionate share of DNI.	The proposal repeals the DNI rules, exempts all distributions from the recipient beneficiary's income, and provides special basis rules for property distributed in kind.
5. Taxation of previously accumulated income	Distributions to beneficiaries out of previously accumulated income are taxed to beneficiaries under a throwback rule designed to tax the income upon distribution at the beneficiaries' average marginal rate in the previous five years.	The throwback rules continue to apply and would be expanded to apply to income accumulated while a beneficiary was under 21 years of age. In addition, the President's proposal suggests that it may be appropriate to impose an interest charge on the tax payable with respect to an accumulation distribution.	The proposal would repeal the throwback rules.

Item	Present Law	President's Proposal	Possible Option
6. Grantor trusts	Under certain circumstances, the grantor (or other person having the power to revoke the trust) is taxed directly on trust income. *The grantor.*—The grantor generally is treated as the owner of all or a portion of the trust if (1) the grantor has a reversionary interest expected to return to him within ten years; (2) the grantor has the power to control beneficial enjoyment of the income or corpus; (3) the grantor retains certain administrative powers; (4) the grantor retains the right to revoke the trust at any time during the first ten years of the trust's existence; or (5) the income of the trust may be distributed to the grantor or the grantor's spouse during the first ten years of the trust's existence. *Persons other than the grantor.*—A person other than the grantor is treated as the owner of all or a portion of the trust if (1) that person has the power to revoke the trust, or (2) that person surrendered the power to revoke and that person retained one of the powers listed above.	The President's proposal limits the circumstances under which a grantor would be treated as the owner of the trust. A grantor would be taxed directly on trust income only if: (a) payments of trust property are required to be made to, or for the benefit of, the grantor or the grantor's spouse; (b) payments may be made to or for the benefit of the grantor or the grantor's spouse— (i) under a discretionary power to make payments, or (ii) by exercise of a power to revoke or amend the trust, which power is in the grantor or the grantor's spouse; (c) the grantor or the grantor's spouse has any power to cause the trustee to lend trust income or corpus to either of them without adequate security and interest; or (d) the grantor or the grantor's spouse has borrowed trust income or corpus and has not completely repaid the loan or any interest thereon before the beginning of the taxable year.	The grantor trust rules would be modified so that they applied only where there are (1) certain administrative powers which permit indirect control over the trust assets, (2) a power to revoke, or (3) a power to control income.

Item	Present Law	President's Proposal	Possible Option
7. Estates	A decedent's estate is treated as a separate taxable entity, beginning as of the date of death. The estate may elect a taxable year different than the decedent's taxable year. Under present law, an estate is allowed a $600 personal exemption and otherwise computes its tax liability generally in the same manner as a nongrantor trust, except that the throwback rules do not apply.	The President's proposal would— (1) provide that an estate would be treated as a separate taxable entity; (2) require the estate to adopt the same taxable year as the decedent; (3) subject an estate to tax at a separate rate schedule, with no personal exemption and no zero bracket amount, but with a deduction for distributions to beneficiaries; (4) exempt any estate with less than $600 of gross income from Federal tax liability; and (5) continue the taxable year of the decedent after his death as if the decedent died on the last day of his taxable year. *Effective date.*—The President's proposal generally would apply to irrevocable trusts created after December 31, 1985, and to trusts that are revocable on January 1, 1986, for taxable years beginning on or after that date. If additional amounts are contributed after December 31, 1985, to a trust that is irrevocable on that date, the trust would be treated as created after that date. For other trusts that are irrevocable on December 31, 1985, certain of these rules will apply, with modifications.	Under the proposal— (1) an estate would be treated as a separate taxable entity that was required to adopt the same taxable year as the decedent; (2) an estate would be taxable at the same rates as a single individual, calculated without a zero bracket amount but with a personal exemption of $600; and (3) no distribution deductions would be allowed. *Effective date.*—The proposal generally would apply to irrevocable trusts created after September 25, 1985, and to trusts that are revocable on September 25, 1985, for taxable years beginning on or after that date. If additional amounts are contributed after September 25, 1985, to a trust that is irrevocable on that date, the trust would be treated as created after that date. Other trusts that are irrevocable on September 25, 1985, would continue to be subject to tax under present law.

Item	Present Law	President's Proposal	Possible Option
Generation-Skipping Transfer Tax	A generation-skipping transfer tax (GST tax) is imposed on transfers under a trust or similar arrangement having beneficiaries in more than one generation below that of the grantor of the trust. Subject to certain transition rules, the GST tax applies to transfers occurring after June 11, 1976.	A separate Treasury Department proposal, introduced in the 98th Congress, would modify the GST tax as follows:	The previously introduced Treasury proposal would be adopted with the following modifications:
1. Taxable transfers	The GST tax is imposed on taxable terminations under and taxable distributions (other than income) from a trust or a similar arrangement in which beneficiaries in more than one generation younger than that of the grantor have an interest (or certain powers over the property) (i.e., generation-sharing arrangements). Direct transfers to persons more than one generation below that of the grantor are not subject to GST tax (i.e., direct skips).	The modified GST tax would be imposed on taxable terminations and taxable distributions (including distributions of income) under generation-sharing arrangements, as under present law. Taxable beneficiaries would include only persons having interests in (as opposed to powers over) property. Direct skips would be subject to tax.	Same as Treasury proposal, except a provision would be added under which direct skips to grandchildren would not be treated as generation-skipping transfers if the grandchild's parent who was a lineal descendant of the transferor was deceased when the transfer occurred.
	In the case of trusts having beneficiaries assigned to three or more younger generations, GST tax is imposed on the termination of the interests (or powers) of each of the intermediate younger generations (when the trust proper.y is not subject to gift or estate tax).	In the case of trusts having beneficiaries assigned to three or more younger generations, GST tax would be imposed only on the termination of the oldest such generation.	Same as present law.
2. Exemption from tax	There is no specific exemption or credit that a grantor may apply against GST tax; however, if a generation-skipping transfer occurs at or after the deemed transferor's death, any unused portion of the deemed transferor's gift and estate tax unified credit may be applied against GST tax. Additionally, a special $250,000 per deemed transferor exemption is permitted for transfers to grandchildren.	A specific exemption of $1 million per transferor would be provided in lieu of the present credit and grandchild exclusion. The specific exemption would be transferable between spouses. Rules would be provided for allocation of unused exemption amounts remaining after the death of a transferor. Under a special rule, certain trust beneficiaries could receive up to $10,000 per year in generation-skipping transfers free of GST tax.	Same as the Treasury proposal except generation-skipping transfers by married individuals would be treated as made one-half by each spouse pursuant to rules similar to the present gift tax rules on such gifts to third persons, and the additional $10,000 exemption for distributions to certain generation-skipping beneficiaries would be deleted.
3. Tax rate	The GST tax is imposed at the gift or estate tax rate that would be imposed if the ,roperty were transferred to the beneficiary by a deemed transferor (generally, the parent of the beneficiary). GST tax on taxable terminations is determined on a tax-inclusive basis (like the estate tax) and taxable distributions are taxed on a tax-exclusive basis (like the gift tax).	All generation-skipping transfers would be subject to tax at a flat rate, equal to 80 percent of the maximum gift and estate tax rate. GST tax on transfers under generation-sharing arrangements would be determined on a tax-inclusive basis; tax would be determined on a tax-exclusive basis on direct skips.	All generation-skipping transfers would be subject to tax at a flat rate, equal to the maximum gift and estate tax rate (presently, 55%; scheduled to decline to 50% in 1988). GST tax would be determined as provided in the Treasury proposal.

Item	Present Law	President's Proposal	Possible Option
4. Credit for State taxes	A limited credit against GST tax is permitted for State death taxes imposed on generation-skipping transfers (based on the deemed transferor concept).	A credit against GST tax would be permitted equal to 5 percent of State taxes on generation-skipping transfers.	No credit would be allowed for State taxes on generation-skipping transfers.
5. Effective dates			The amended GST tax would apply to transfers after the date of enactment, subject to the following exceptions: (1) Inter vivos transfers occurring after September 25, 1985, would be subject to the amended tax; (2) Transfers from trusts that were irrevocable before September 26, 1985, would be exempt to the extent that the transfers were not attributable to additions to the trust corpus occurring after that date; and (3) Transfers pursuant to wills in existence before September 26, 1985, would not be subject to tax if the decedent was incompetent on that date and at all times thereafter until death. The present GST tax would be repealed, retroactive to June 11, 1976.

XIII. COMPLIANCE AND TAX ADMINISTRATION

Item	Present Law	President's Proposal	Possible Option
. Penalties			
1. Penalties relating to information returns	The Code provides a $50 penalty for each failure to file an information return with the IRS and each failure to supply a copy of the information return to the taxpayer. The maximum penalty is generally $50,000. The Code also provides a $5 penalty ($50 under certain circumstances) for failure to furnish a correct taxpayer identification number. There is no specific penalty for including other incorrect information on an information return.	a. Eliminate the $50,000 maximum, b. Impose a new $5 penalty for suppling incorrect information (with a reasonable cause exception), and c. Consolidate the existing penalty for failure to file information returns with the IRS with the existing penalty for failure to supply a copy of the information return to the taxpayer. *Effective date.*—Returns due on or after January 1, 1986 (without regard to extensions).	Generally the same as the President's proposal, except provide a $100,000 maximum penalty.
2. Penalty for failure to pay taxes	A taxpayer who fails to pay taxes when due must pay a penalty of one-half of one percent of the tax for the first month not paid. The penalty increases by one-half of one percent for each month the failure to pay continues, up to a maximum of 25 percent.	Replace the penalty for failure to pay taxes with a cost of collection charge. The goal of the proposal is to recover IRS' costs of collecting delinquent payments. *Effective date.*—Returns due on or after January 1, 1986 (without regard to extensions).	Generally the same as the President's proposal, clarified as follows: Increase the penalty for failure to pay from one-half of one percent to one percent per month (up to the 25 percent limit) after the taxpayer has been notified that the IRS will levy upon the taxpayer's assets to collect the past-due taxes. This is the point at which the IRS uses more expensive collection methods. *Effective date.*—Failure to pay on or after January 1, 1986.
3. Negligence and fraud penalties	(a) The Code provides penalties for negligence and fraud. Both penalties have two components. The first is a time-sensitive component. The second is a specified percentage (5 percent for negligence, 50 percent for fraud) of the entire underpayment of tax if any portion of the underpayment is due to negligence or fraud. (b) A special negligence penalty applies to failures to include on a tax return interest or dividends that were reported to the taxpayer on an information report, in the absence of clear and convincing evidence that there was no negligence. (c) The general negligence penalty does not apply to all taxes imposed by the Code.	No provision.	(a) Apply the negligence and fraud penalties only to the portion of the underpayment of tax attributable to negligence or fraud; increase the 5 percent component of the negligence penalty to 10 percent and increase the 50 percent component of the fraud penalty to 75 percent. (b) Apply the special negligence penalty to all failures to include on a tax return items subject to information reporting. (c) Apply the general negligence penalty to all taxes imposed by the Code. *Effective date.*—Returns required to be filed on or after January 1, 1986.

Item	Present Law	President's Proposal	Possible Option
4. Penalty for overstatement of pension liabilities	A penalty may apply if deductions are based on a significant overstatement of the value of an item (such as a charitable deduction). The level of the penalty varies, depending on the degree of the overstatement. A similar penalty applies to underpayments of estate or gift tax due to valuation understatements. There is no current penalty for an overstatement of liabilities under a pension plan.	No provision.	Provide a new penalty on actuaries for underpayments of tax due to overstatements of liabilities under a pension plan. New penalty would be similar to the current underpayment penalty. *Effective date.*—Overstatements with respect to 1986 and later returns.
Return-Free System	Individuals whose income exceeds specified levels must file income tax returns each year. Generally, these returns must be filed by April 15, unless the taxpayer receives an extension of time to file.	Provide the IRS with the authority to implement a return-free system for individuals. Taxpayers who meet certain criteria (relating to the complexity of their returns) would be offered the option of not filing an income tax return. Instead, the IRS would prepare the return and compute the tax liability of the taxpayer. The IRS would do this using wage reports currently filed with the Social Security Administration and information returns currently filed with the IRS. The IRS would send the taxpayer a report stating the Service's calculation of the taxpayer's tax liability. The taxpayer would be free to challenge the Service's calculation of tax. *Effective date.*—Not specified in Administration proposal.	While this appears to be an idea worth exploring, the proposal has not yet been sufficiently developed for the committee to make an informed decision. Therefore, require a report from IRS to Congress due in 6 months. Report would state: (a) Who can participate in proposal and who cannot; (b) How the proposal would be phased in; and (c) What resources (computers, staff, etc.) are needed. The IRS should also consider whether an in-house test of the proposal (not involving taxpayers) would be beneficial. *Effective date.*—Report due in six months.
Estimated Tax Payments by Individuals	Individuals owing tax who do not have sufficient taxes withheld from their wages must make estimated tax payments. These payments must equal at least the lesser of 100 percent of last year's tax liability or 80 percent of the current year's tax liability.	No provision.	Require that individuals must make estimated tax payments that equal at least the lesser of 110 percent (rather than 100 percent) of last year's tax liability or 90 percent (rather than 80 percent) of the current year's tax liability. *Effective date.*—Payments due on or after January 1, 1986.
Interest on Underpayments of Accumulated Earnings Tax	The Code imposes the accumulated earnings tax to prevent corporations from accumulating (rather than distributing) dividends with the intent of reducing or avoiding taxes. Interest is charged only from the date IRS demands payment of the tax, rather than the date the return was originally due to be filed.	No provision.	Charge interest on underpayments of the accumulated earnings tax from the date the return was originally due to be filed. *Effective date.*—Returns due in 1986.

Item	Present Law	President's Proposal	Possible Option
Modification of Employee Withholding Allowance Forms	Employees can claim withholding allowances on Form W-4. That form determines how much in Federal taxes is withheld from the employee's wages. Withholding allowances can be claimed for personal exemptions, tax credits, and estimated deductions (such as itemized deductions). That form remains in effect until the taxpayer changes or revokes it.	No provision.	Modify withholding schedules to better approximate the newly effective rate schedules. *Effective date.*—January 1, 1986.
Awards of Attorneys' Fees in Tax Cases	Attorneys' fees may be awarded in tax cases to private parties who prevail on the issues litigated if the taxpayer proves that the government's position was unreasonable. Awards are limited to $25,000. GAO has stated, however, that there is no appropriation currently available to pay Tax Court awards. This provision expires with respect to court proceedings commmenced after December 31, 1985.	No provision.	Extend the present-law sunset date until December 31, 1989. Authorize funding of attorney fee awards out of source used in non-tax cases.
Exhaustion of Administrative Remedies	A taxpayer may go directly to Tax Court without requesting review by the administrative appeals office within the IRS. After the case is opened in the Tax Court, it is sent to the IRS appeals office for settlement. Many of these cases are then settled without significant involvement by the Court.	No provision.	Require taxpayers to have their cases reviewed by the IRS administrative appeals office as a jurisdictional prerequisite to Tax Court review. After review by the IRS appeals office (or the expiration of 6 months, whichever comes first), the taxpayer could then go to the Tax Court. If taxpayers did not allow review by the appeals office, access to prepayment review by the Tax Court would not be permitted. The liability could still be contested in a refund suit before a Federal district court or the Claims Court. Require Tax Court and IRS to report to Congress annually on Tax Court inventory and measures taken to close cases more efficiently. *Effective date.*—Cases filed in the Tax Court after January 1, 1987.