[JOINT COMMITTEE PRINT]

SUMMARY OF ADMINISTRATION'S REVENUE PROPOSALS IN THE FISCAL YEAR 1985 BUDGET PROPOSAL

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This document, prepared by the staff of the Joint Committee on Taxation, provides a summary of the Administration's revenue proposals made in the Fiscal Year 1985 Budget, submitted to the Congress on February 1, 1984.

The first part of the document is an overview of the Administration's revenue proposals. The second part is a brief summary of the budget proposal. The third part is a summary of the revenue proposals, including present law and a reference to prior action (if any) on the topic. The fourth part presents the Treasury Department's estimates of the revenue effect of the Administration's proposals. Finally, an Appendix contains additional revenue tables from Treasury Department data relating to budget receipts by source and effects of recent tax legislation on budget receipts.

The staff summary is based upon information available from the Fiscal Year 1985 Budget and associated documents, and from the Treasury Department's "Fact Sheet" with respect to the revenue proposals.

The description of revenue proposals contained in this document does not include the following items listed in the revenue section of the Administration's Fiscal Year 1985 Budget: (1) changes in contributions to civil service retirement; (2) extension of Federal/State unemployment insurance coverage to railroad retirement; and (3) petroleum overcharge restitution fund (fiscal year 1984 effect only). The Administration's revenue estimates for these provisions for fiscal years 1985–1987 are noted, however, in the summary revenue table in Part IV of this document.

I. OVERVIEW OF ADMINISTRATION'S REVENUE PROPOSALS

The Administration's fiscal year 1985 budget document includes a number of revenue increase proposals that it estimates will increase revenues in the aggregate by $9.1 billion in fiscal year 1985 and by $40.4 over the three-year period of fiscal years 1985–1987. The budget also proposes several revenue reduction measures that would in the aggregate decrease budget receipts by $1.9 billion in fiscal year 1985 and by $10.6 billion over the fiscal years 1985–1987. The overall effect on budget receipts of the Administration's revenue proposals is to increase net revenues by $7.8 billion in fiscal year 1985 and by $33.5 billion over the three-year period. (See the table in Part IV.) Further, the budget includes other revenue-related proposals that the Administration estimates will not have a long-run impact on revenues.

Revenue increase items

The Administration's budget includes the following proposed revenue increase items:

(1) A limitation on the exclusion for employer-provided health insurance premiums (i.e., inclusion of part of those premiums in taxable income and in wages for employment tax purposes).

(2) A reduction in the tax benefits available for certain property that is leased to or otherwise used by tax-exempt entities.

(3) Imposition of a $150 per capita annual volume cap on the amount of tax-exempt industrial development bonds and student loan bonds that States and localities can issue, a reduction of accelerated cost recovery deductions for certain facilities financed with IDBs, and imposition of other restrictions limiting the use of IDBs.

(4) The following proposals would deal with partnership and other tax shelter abuses, accounting issues, and provide certain corporate reforms with respect to dividends, mutual funds and foreign corporations.

(a) The Administration's budget contains the following proposals to deal with partnership and other tax shelter-related problems:

(i) In the case of cash basis partnerships and tiered arrangments, partnership taxable income or loss would be allocated over the taxable year on a daily basis.

(ii) Gain or loss from a sale of property contributed to a partnersip would be allocated to the contributing partner. Certain deductions from contributed property would be allocated to the partners in proportion to their basis in the partnership attibutable to capital contributions. Contributed property would retain its character for five years.

(iii) Allocations of partnership income to permit the current deduction of otherwise capital expenditures would be prohibited.

(iv) When a partnership interest is sold or exchanged, the partnership would be treated as directly owning its share of property owned by a partnership in which it has an interest, for purposes of determining the amount of ordinary income to the taxpayer.

(v) Tax-free like-kind exchanges would have to be completed within 90 days after the taxpayer transfers the property to be used in the exchange. Exchanges of partnership interests would no longer be tax-free like-kind exchanges.

(vi) Gain on the disposition of a bond reflecting accrued market discount would be taxed as interest income on the disposition of the bond.

(vii) A deduction for charitable contributions of certain appreciated property would be limited to the basis of the property unless the property has been held by the taxpayer for at least three years. The overvaluation penalty would apply notwithstanding that the property has been held for over five years.

(b) The Administration's budget contains the following proposals to deal with accounting and time-value-of-money related problems:

(i) Interest would be required to be accounted for on a consistent interest method in certain deferred payment transactions.

(ii) Syndicates generally would not be allowed a deduction for prepaid expenses.

(iii) Certain interest-free and low-interest loans would be recharacterized as arm's-length transactions.

(iv) Income and deductions would be required to be matched in related party transactions, including transactions between partnerships and partners.

(v) LIFO conformity could not be avoided by using subsidiary corporations.

(vi) A taxpayer could not accrue deductions far in advance of the occurrence of the event which gives rise to the deductible obligation.

(vii) The loss deferral and other straddle rules would be made applicable when a taxpayer owns stock in a corporation holding positions that offset positions directly held by a taxpayer.

(viii) The accumulated earnings tax would be made applicable to earnings from U.S. sources, even though they have been distributed as a dividend to a foreign corporation in certain cases, and foreign investment companies would be defined to include corporations trading in commodities, resulting in ordinary income to U.S. shareholders in such companies.

(ix) The exemption from the straddle rules for exchange-traded stock options would be terminated. Stock offset by a stock option would also be subject to such rules. An exemption would apply to certain covered call options.

(x) Market-makers and other professional traders in options would be taxed under a mark-to-market system of accounting with respect to all their option positions.

(xi) Gain or loss would be recognized on the exercise of options on regulated futures contracts.

(xii) The tax rules applicable to options would be expressly applicable to cash settlement options.

(c) The Administration's budget contains the following proposals for corporate tax reforms:

(i) The deduction for interest paid or accrued by a corporation on an obligation the proceeds of which are used to purchase or carry portfolio stock would be limited to the extent of the deduction for any dividends received on such stock.

(ii) Payments in lieu of extraordinary dividends with respect to stock sold short would not be deductible against ordinary income if the closing of the short sale occurs less than one year after the short sale itself. For ordinary dividends, the short position would be required to be held open for 16 days. Amounts paid to a lender of stock in lieu of such dividends would be treated as part of the short seller's basis in the stock acquired to close the short sale. Payments incurred on short sales not capitalized under these rules would be treated as interest limited or disallowed as investment interest or as interest incurred on obligations to carry tax-exempt obligations.

(iii) The fair market value of extraordinary dividends (to the extent not subject to tax) would reduce the basis in stock held one year or less by a corporation. The shareholder corporation's holding period for dividends of property could not exceed its holding period for its stock in the distributing corporation.

(iv) Any ordinary, non-liquidating distribution of appreciated property would be taxable to the distributing corporation. Certain exceptions of present law (relating to, among other things, carryover basis situations) would remain.

(v) Corporate distributions and liquidating sales of partnership interests would be treated as transfers of the distributing corporation's allocable share of certain of the partnership properties. Gain would be recognized to the corporation to the same extent as if these properties were distributed or sold.

(vi) A collapsible corporation would be required to realize at least two-thirds of the taxable income from the property causing its collapsible status.

(vii) Gain would be recognized, without regard to purpose, upon the transfer of appreciated property to a foreign corporation which is not for use in an active trade or business outside the United States. An automatic toll charge would be imposed on transfers of certain tainted assets with the exception of transfers of stock. Also, tax-free transfers abroad of intangibles would be ended. The overlap of loss recapture provisions would be prevented.

(viii) Certain transfers of the stock of a U.S. parent corporation to its foreign subsidiary by shareholders of the U.S. parent would be treated as if the U.S. parent had exchanged a portion of the subsidiary's stock, subjecting the parent to tax at ordinary income rates on certain deferred earnings of the subsidiary.

(5) A withholding system to collect the tax on gains recognized by foreign persons would be imposed on the disposition of U.S. real property.

Revenue decrease items

The Administration's budget also includes the following proposed revenue reduction items:

(1) A series of incentives to invest in areas designated as enterprise zones.

(2) Provision of a nonrefundable income tax credit of 50 percent of certain tuition expenses paid to private elementary and secondary schools subject to a dollar limitation ($100 in 1984, $200 in 1985, and $300 in 1986 and thereafter), and with a phase out of the credit for taxpayers with adjusted gross income (AGI) of $40,000 to $60,000.

(3) Tax exclusion for interest and dividends earned on amounts deposited in qualified education savings accounts, with a phaseout of the exclusion for taxpayers with AGI of $40,000 to $60,000.

(4) Increasing the deductible Individual Retirement Account (IRA) amount for a noncompensated spouse to $2,000 from the present $250.

(5) Treating alimony payments as compensation for purposes of an IRA deduction.

(6) Treating a dependent care organization providing nonresidential care to the general public to enable individuals to be gainfully employed as a tax-exempt charity.

(7) Increasing the tax credit for employment-related dependent care to 40 percent for individuals with AGI of less than $11,000 with the percentage decreasing to zero at AGI of $60,000 or more.

(8) An exemption from income tax for the income of any military or civilian U.S. employee who dies as a result of foreign terroristic or military action after 1979.

(9) A three-year (through December 31, 1988) extension of the credit for increased research expenses modified to cover only expenditures for the development of new or significantly improved products or processes.

(10) A two-year extension of the moratorium on allocating U.S. research and experimentation expenditures to foreign sources.

(11) A one-year extension of the targeted jobs tax credit.

(12) An extension of the special tax deferral rules covering the 1983 Payment-in-Kind (PIK) program to the 1984 wheat PIK program.

(13) Replacement of the existing three-phase structure of taxation of life-insurance companies by a single-phase tax, more like that imposed on other business corporations, and an adoption of a permanent definition of life insurance contracts.

Other items

The Administration's budget also includes the following items that it estimates would have negligible revenue effects:

(1) A replacement of the present Domestic International Sales Corporation (DISC) provisions with an offshore entity that would be exempt from tax on certain export income.

(2) Provision for a new pass-through entity to hold mortgages and issue various classes of securities, referred to as a trust for investment in mortgages (TIM).

(3) Provision that a cafeteria plan may offer employees choices only among cash or those fringe benefits (other than scholarships or fellowships, educational assistance, and vanpooling) that are excludable from gross income under a specific Code provision.

II. SUMMARY OF ADMINISTRATION'S BUDGET PROPOSAL

A. Overview for 1985

For fiscal year 1985, the Administration's budget proposes total outlays of $925.5 billion, total receipts of $745.1 billion, and a deficit of $180.4 billion.

B. Budget Totals: Outlays, Receipts and Deficits

Table 1 shows past budget totals for recent fiscal years and the Administration's estimates of current and future budget totals under its proposal. In addition, these amounts are shown as percentages of the gross national product (GNP), which is the market value of all goods and services produced by the nation's economy during the fiscal year. The general purpose of expressing budget totals as percentages of GNP is to indicate the size of Federal governmental activities relative to the size of the national economy.

Table 1.—Unified Budget Outlays, Receipts and Deficits

[Dollar amounts in billions]

Fiscal year	Outlays		Receipts		Deficit	
	Amount	Percent GNP	Amount	Percent GNP	Amount	Percent GNP
1970–79 [1]		20.8		18.9		1.9
1980	576.7	22.4	517.1	20.1	59.6	2.3
1981	657.2	22.8	599.3	20.8	57.9	2.0
1982	728.4	23.8	617.8	20.2	110.7	3.6
1983	796.0	24.7	600.6	18.6	195.4	6.1
1984 [2]	853.8	24.0	670.1	18.8	183.7	5.2
1985 [2]	925.5	23.8	745.1	19.2	180.4	4.6
1986 [2]	992.1	23.4	814.9	19.3	177.1	4.2
1987 [2]	1,068.3	23.3	887.8	19.3	180.5	3.9
1988 [2]	1,130.3	22.8	978.3	19.7	152.0	3.1
1989 [2]	1,183.7	22.1	1,060.3	19.8	123.4	2.3

[1] Average during the 10-year period.
[2] Estimate.

Budget outlays

Budget outlays in fiscal year 1985 are expected by the Administration to increase by 8.4 percent over the estimated amount for 1984. Thereafter, the average annual rate of growth in spending would decelerate to 7.4 percent between 1985 and 1987, and decelerate even more to 5.3 percent between 1987 and 1989. Government spending as a percentage of GNP would be slightly less in 1985 than in 1984, and would continue to decline through 1989. However, in the near term, the share of GNP estimated to be spent by the Federal government would remain high by historical standards. For example, outlays averaged 20.8 percent of GNP during the 1970's, as compared with the 23.8 percent projected for 1985. One percent of GNP in fiscal year 1985 would be about $39 billion.

Budget receipts

Budget receipts in fiscal year 1985 are projected by the Administration to rise by 11.2 percent over the estimated amount for 1984, and to continue to rise thereafter at an average annual rate of 9.2 percent through 1989. As a percentage of GNP, Federal budget receipts would rise to 19.2 percent in 1985 and 19.8 percent by 1989. Thus, Federal budget receipts over the 1985–1989 period are forecasted to be a somewhat higher proportion of GNP than they were, on average, in the 1970's. Estimates of receipts reflect not only the proposed revenue measures in the budget but also the effects of recent legislation, including the tax cuts enacted in the Economic Recovery Tax Act of 1981, the revenue gains provided by the Tax Equity and Fiscal Responsibility Act of 1982, the increase in Highway Trust Fund revenues arising from the Highway Revenue Act of 1982, the increased tax collections provided by the Social Security Amendments of 1983, the reduced revenues from repealing withholding on interest and dividends as provided by the Interest and Dividend Tax Compliance Act of 1983 (IDTCA), and the tax increases enacted in the Railroad Retirement Revenue Act of 1983. As shown in table 2, the Administration estimates that the net effect of major tax laws enacted in 1981–83 is to reduce tax receipts by $73 billion in 1983, $114 billion in 1985, and $173 billion in 1987. More detail on the effects of enacted legislation on budget receipts appears in the Appendix.

Table 2.—Net Effect of Major Tax Legislation Enacted in 1981–83 [1]

[Fiscal years; billions of dollars]

	1983	1984	1985	1986	1987	1983–87
ERTA of 1981	−91.1	−133.6	−165.0	−207.7	−248.5	−845.9
TEFRA of 1982	16.6	35.4	39.7	49.3	60.7	201.8
Highway Revenue Act of 1982	1.5	4.1	4.2	4.4	4.5	18.7
Social Security Amendments of 1983		6.2	8.8	9.3	11.4	35.8
IDTCA of 1983	−.1	−2.6	−2.4	−2.1	−1.7	−8.8
Railroad Retirement Revenue Act of 1983	(2)	.2	.7	1.1	1.1	3.1
Net tax reduction	−73.0	−90.3	−113.8	−145.7	−172.6	−595.4

[1] These estimates are based on the direct effect only of legislative changes at a given level of economic activity. Induced effects are taken into account for forecasting incomes, however, and in this way affect the receipts estimates in total.
[2] $50 million or less.

Budget deficits

The Administration estimates that under its proposed budget the Federal deficit in fiscal year 1985 will be $180.4 billion. This would be virtually the same amount as expected for 1984. As shown in table 1, deficits under the Administration's proposal would continue in the range of $180 billion through 1987, but would decline as a percentage of GNP from 4.6 percent in 1985 to 3.9 percent in 1987. Deficits on the order of 4 to 4.5 percent of GNP would be quite high by historical standards. For example, they would be about twice the relative size of deficits experienced in the 1970's, during which deficits averaged 1.9 percent of GNP. However, the Administration estimates that budget deficits will begin to decline significantly in fiscal year 1988, due in part to a significant deceleration in the projected growth rate in spending, and will fall to 2.3 percent of GNP by 1989.

C. Composition of Outlays and Receipts

Trends in budget outlays

Total budget outlays are expected by the Administration to grow at an average annual rate of 7.8 percent over the period 1984–1987. As shown in table 3, national defense spending would grow much more rapidly (13.6 percent annually) than outlays in general. Interest payments and payments to individuals, generally defined as payments for which an individual currently provides no goods or services, would grow less rapidly (6.6 percent annually in each category) than total outlays. Spending in the rest of the budget (inclusive of offsetting receipts) would contract at an average annual rate of 2.4 percent. By fiscal year 1987, the proportion of total outlays used to make payments to individuals is expected to have declined to 46.9 percent, which would be somewhat higher than its average budget share over the 1970's. Spending in 1987 for national defense and net interest is projected to be 32.6 percent and 12.3 percent of total outlays, respectively, in each case a higher budget share than the average over the 1970's. Less than 10 percent of total outlays in 1987 would be made in the remaining areas of the budget, whereas such spending averaged 18.0 percent of total outlays during the 1970's.

Table 3.—Composition of Federal Budget Outlays

[Percent of total budget outlays]

Fiscal year	National defense	Payments to individuals	Net interest	Other
1970–79 [1]	29.7	44.9	7.5	18.0
1980	23.2	49.1	9.1	18.6
1981	24.0	50.3	10.5	15.3
1982	25.4	49.9	11.7	12.9
1983	26.4	50.6	11.3	11.8
1984 [2]	27.8	48.4	12.7	11.1
1985 [2]	29.4	47.6	12.5	10.4
1986 [2]	31.3	47.3	12.5	8.9
1987 [2]	32.6	46.9	12.3	8.3
Annual growth rate 1984–87	13.6	6.6	6.6	−2.4

[1] Average during the 10-year period.
[2] Estimate.

Trends in budget receipts

Total budget receipts are expected by the Administration to grow at an average annual rate of 9.6 percent over the 5-year period 1984–1989. As shown in table 4, individual income tax receipts are projected to grow the most rapidly (10.8 percent annually) over this period, followed by social insurance taxes and contributions (10.5 percent annually). Corporate income taxes are expected to grow somewhat more rapidly (10.1 percent annually) than budget receipts in general. Estate and gift taxes, excise taxes, and miscellaneous receipts are expected to decline between 1984 and 1989. The Administration forecasts that, among the major sources of revenue, social insurance taxes will constitute a much higher proportion of total receipts by 1989 than they did in the 1970's, individual income taxes about the same proportion, and corporate income taxes a lower proportion. Projections of amounts to be collected, by source, appear in the Appendix.

Table 4.—Composition of Federal Budget Receipts

[Percent of total budget receipts]

Fiscal year	Individual income tax	Corporate income tax	Social insurance taxes	Excise taxes	Estate and gift taxes	Customs duties	Misc. receipts
1970–79 [1]	45.3	15.0	28.1	6.3	1.8	1.4	2.0
1980	47.2	12.5	30.5	4.7	1.2	1.4	2.5
1981	47.7	10.2	30.5	6.8	1.1	1.4	2.3
1982	48.2	8.0	32.6	5.9	1.3	1.4	2.6
1983	48.1	6.2	34.8	5.9	1.0	1.4	2.6
1984 [2]	43.8	9.9	35.7	5.7	.9	1.4	2.6
1985 [2]	44.1	10.3	36.3	5.2	.8	1.3	2.1
1986 [2]	44.7	10.8	36.5	4.2	.6	1.2	2.0
1987 [2]	45.2	11.0	36.5	3.8	.5	1.1	1.8
1988 [2]	45.7	10.6	37.0	3.5	.4	1.1	1.7
1989 [2]	46.3	10.2	37.2	3.3	.4	1.0	1.6
Annual growth rate 1984–89	10.8	10.1	10.5	−2.0	−4.4	4.1	−1.1

[1] Average during the 10-year period.
[2] Estimate.

D. Economic Assumptions for the Budget

The economic assumptions which underlie forecasts in the Administration's 1985 budget are shown in table 5.

Table 5.—Administration's Economic Assumptions

[Calendar years]

	Actual		Forecast					
	1982	1983 [1]	1984	1985	1986	1987	1988	1989
Real GNP, percent change	−1.7	6.1	4.5	4.0	4.0	4.0	4.0	3.8
CPI, percent change [2]	4.5	2.9	4.5	4.7	4.4	4.1	3.8	3.5
Unemployment rate (percent) [3]	10.5	8.4	7.7	7.5	7.2	6.5	5.8	5.7
Interest rate, 91-day Treasury bills (percent) [4]	10.7	8.6	8.5	7.7	7.1	6.2	5.5	5.0

[1] Preliminary.

[2] CPI for urban wage earners and clerical workers. The index shown here is that currently used, as required by law, in calculating automatic cost-of-living increases for indexed Federal programs. The manner in which this index measures housing costs will change significantly in 1985.

[3] Percent of total labor force (including resident armed forces), fourth quarter.

[4] Average rate on new issues within period, on a bank discount basis. These projections assume, by convention, that interest rates decline with the rate of inflation. They do not represent a forecast of interest rates.

The Administration assumes that real GNP (which is the gross national product measured in dollars of constant value) will be 4.5 percent higher in the fourth quarter of 1984 than it was in the fourth quarter of 1983. Real GNP is then assumed to grow at about 4 percent per year through 1989.

The Administration assumes that employment will improve gradually as economic growth proceeds. The fourth-quarter unemployment rate for the total labor force (including resident armed forces), which was 8.4 percent in 1983, is forecast to decline to 7.7 percent in 1984 and to 5.7 percent by 1989.

The Administration forecasts that inflation will be somewhat higher than in 1983. As measured by the annual growth (fourth quarter over fourth quarter) in the Consumer Price Index for urban wage earners and clerical workers, the inflation rate, which was 2.9 percent in 1983, is assumed to rise to 4.5 percent in 1984, 4.7 percent in 1985, and to taper thereafter. In addition, the Administration assumes a steady decline in interest rates, beginning in 1985. The 91-day Treasury bill rate is assumed to fall from 8.6 percent in 1983 to 7.7 percent in 1985 and to 5.0 percent by 1989.

Small differences in the estimated growth of real GNP have an impact on projected deficits that grows over the forecast period. As shown in table 6, the Administration estimates that if the annual real GNP growth rate were 1 percentage point less than has been assumed in the budget (with no change in the rate of inflation), then the deficit, on a current law basis, would increase by $4.2 billion in 1985, $31.8 billion in 1987, and $70.3 billion in 1989. Conversely, if real GNP growth were 1 percent more than has been assumed, there would be similar reductions in the projected deficits.

Table 6.—Increase in Deficit Due to Slower Growth

[Billions of dollars, current law basis]

Real GNP growth rate	Fiscal Years				
	1985	1986	1987	1988	1989
1% below forecast[1]	4.2	16.6	31.8	49.9	70.3

[1] Beginning January 1985.

E. Current Services Budget

One perspective on the fiscal year 1985 budget proposal is to compare projected budget outlays and receipts with the current services budget (CSB). The CSB measures the budget receipts and outlays which would occur if current spending and tax programs were continued without change. The Administration projects that the CSB deficit in 1985 will be $208 billion, or $28 billion more than the proposed budget deficit. As shown in table 7, $19 billion of the savings comes from outlay reductions, of which $17 billion is the direct result of programmatic reductions, and $2 billion is attributable to reduced borrowing costs. The deficit is narrowed, relative to the continuation of current law, by an additional $8 billion as a result of the Administration's proposed revenue measures. In the absence of the spending and revenue programs proposed in the fiscal year 1985 budget, the Administration estimates that the deficit would rise to $220 billion in 1987, $40 billion more than the proposed budget.

Table 7.—Reconciliation of Current Services Budget Deficit and Proposed Budget Deficit

[Billions of dollars]

	1985	1986	1987	1988	1989
Current services deficit	208	216	220	203	193
Proposed budget deficit	180	177	180	152	123
Proposed deficit reduction	28	39	40	51	70
Components of proposed deficit reduction:					
Total outlay reduction	19	27	26	33	46
Programmatic reduction	17	22	19	23	34
Net interest savings	2	5	7	10	12
Total receipt increase	8	12	14	18	23

III. SUMMARY OF ADMINISTRATION'S REVENUE PROPOSALS

A. Revenue Increase Items

1. Employer Health Plan Premium Cap

Present Law

Under present law, employer contributions to accident or health plans to compensate employees for personal injuries or sickness (through insurance or otherwise) are excluded from an employee's gross income. Amounts paid to or on behalf of an employee under an employer's accident or health plan to reimburse the employee for expenses incurred for medical care (including medical care provided the employee's spouse or dependents) also are generally excluded from the employee's income.

Under present law, employer contributions to accident or health plans for employees, and payments made to employees under such plans, generally are not subject to social security, railroad retirement and unemployment taxes.

Administration Proposal

Under the Administration proposal, for periods after December 31, 1984, employer contributions to accident or health plans for an employee would be included in the employee's income to the extent they exceed (1) $175 per month ($2,100 per year) if the plan covers the employee and his family, or (2) $70 per month ($840 per year) if the plan covers only the employee. The $175 and $70 amounts would be indexed to increase with inflation.

Amounts included in the employee's income under the proposal would also be subject to social security, railroad retirement and unemployment taxes.

There would be a transition rule to delay until January 31, 1986, the application of the proposal with respect to premiums fixed under a contract in effect on January 31, 1983.

Prior Action

A similar proposal was included in the Administration's 1984 budget.

2. Tax-Exempt Entity Leasing

Present Law and Background

The Federal income tax benefits of property ownership generally include the investment tax credit and accelerated depreciation deductions. The investment credit directly reduces tax liability. Accelerated depreciation deductions defer tax liability to later years and thus operate, like the investment credit, to reduce the present value of tax that otherwise would be imposed on an investment. Congress enacted these benefits to reduce the income tax liability of taxpayers and thereby to encourage their purchase and use of capital goods.

These tax benefits of ownership are generally allowed only for property used for a business or income-producing purpose. They are not available for property that is owned by governmental units or tax-exempt organizations. Likewise, to prevent tax-exempt entities from indirectly gaining the benefits of both tax-exemption and the investment tax credit, no investment credit is generally allowed for property that is used by a domestic governmental unit or a tax-exempt organization. For example, property used under a lease by a domestic governmental unit or a tax-exempt organization is ineligible for the investment credit. A statutory exception to this general rule is that qualified rehabilitation expenditures for a building leased to a governmental unit or tax-exempt organization can qualify for the rehabilitation tax credit. Also, one court has held that investment credits can be claimed where a governmental unit essentially contracts not for the use of property itself, but rather for a service to be provided by the property owner (an agreement sometimes referred to as a service contract).

Property that is used (though not owned) by a domestic governmental unit or a tax-exempt organization qualifies for accelerated cost recovery (ACRS) or other depreciation deductions. Thus, property generally denied the benefit of the investment credit is eligible for the benefit of accelerated depreciation deductions. As the lessor passes on the benefits of rapid recovery deductions and interest deductions in the form of lower rents, tax-exempt entities are encouraged to lease property that they would otherwise own (or already own), with a consequent loss of revenue to the Treasury.

The general denial of investment credits for property used by a tax-exempt entity does not cover property used by a foreign government or person. However, if the property is used predominantly outside the United States, then, with exeptions for certain types of property, ACRS deductions are slowed down and no investment credit is allowed.

Administration Proposal

The Administration's proposal would deny the investment tax credit and slow down depreciation deductions for certain property leased to a tax-exempt entity. The general purpose of the proposal is to prevent tax-exempt entities from gaining unintended access to tax benefits through leasing.

The restrictions on the investment credit and on depreciation deductions would apply to property leased to a tax-exempt entity if (i) the property is financed with tax-exempt obligations; (ii) the tax-exempt entity has used the property before selling and leasing it back; (iii) the lease includes a fixed-price purchase or sale option; or (iv) the lease term exceeds 80 percent of the property's useful life. The restrictions would apply to all property leased to the Federal Government. Also, they would apply to all foreign-produced property leased to a foreign person not subject to more than a nominal amount of United States income tax.

The proposal would generally apply to transactions entered into after May 23, 1983. The proposal would not apply to property used under a short-term lease or in cases where use by tax-exempt entities is nominal.

Prior Action

Two bills relating to tax-exempt leasing and similar to the Administration's proposal were approved by the tax-writing committees during the first session of the 98th Congress. They are the Tax-Exempt Entity Leasing Act of 1983 (Title I of H.R. 4170), as reported by the House Committee on Ways and Means, and the Governmental Lease Financing Reform Act of 1983 (Part IV, Subtitle A of S. 2062), as reported by the Senate Committee on the Budget (reconciliation proposal submitted by the Committee on Finance).

3. Private Purpose Tax-Exempt Bonds

Present Law

Overview

Interest on State and local government obligations generally is exempt from Federal income tax. However, interest on industrial development bonds (IDBs) is taxable unless the bonds are issued for certain specified purposes or qualify as small issue IDBs. An IDB is a bond issued by or on behalf of a State or local government, the proceeds of which are to be used (directly or indirectly) in a trade or business and the repayment of which is to be derived from or secured by property to be used in a trade or business.

Exempt purpose IDBs

Under present law, interest on IDBs is tax-exempt if the bonds are issued to finance any of the following activities: (1) projects for low-income residential rental property; (2) sports facilities; (3) convention or trade show facilities; (4) airports, docks, wharves, mass commuting facilities, and parking facilities; (5) sewage and solid waste disposal facilities, facilities for the local furnishing of electricity or gas, and local district heating or cooling facilities; (6) air or water pollution control facilities; (7) certain facilities for the furnishing of water; (8) qualified hydroelectric generating facilities; or (9) qualified mass commuting vehicles. In addition, interest on certain IDBs issued to acquire or develop land as a site for an industrial park is exempt from taxation.

Small issue IDBs

Through 1986, interest on certain "small issue" IDBs is also tax-exempt if the proceeds of the IDBs are used for the acquisition, construction, or improvement of land or depreciable property. Small issue IDBs are issues not exceeding $1 million (unless an election is made to count certain capital expenditures, in which case the limit per issue is $10 million). Certain types of recreational facilities, food and beverage facilities, and automobile sales facilities may not be financed with small issue IDBs.

Other private activity bonds

Present law also allows unlimited tax-exempt financing for student loans and organizations that qualify for tax exemption under section 501(c)(3), such as private, nonprofit hospitals and private, nonprofit educational institutions, where the proceeds of the bonds are used for exempt purposes.

Other rules

Additional rules (discussed below) govern tax-exempt private activity bonds and cost-recovery deductions for property financed with such bonds. Certain statutes other than the Internal Revenue Code also allow specified entities (e.g., the District of Columbia, Puerto Rico, Guam, the Virgin Islands, and certain housing authorities) to issue tax-exempt bonds. These bonds generally are not subject to the Internal Revenue Code restrictions on tax-exempt obligations.

Present law places no limit on the aggregate amount of private activity bonds that a State or local government may issue during any year.

Administration Proposal

Volume limitation

In general

Under the Administration proposal, private activity bonds would be subject to State-by-State annual volume limitations. Private activity bonds generally would include IDBs and student loan bonds issued within the State. Accordingly, the volume limitations would not apply to bonds issued for traditional public activities (e.g., to finance schools and roads).

Each State's volume limitation would be set at $150 for each resident of the State, as determined according to the most recent census estimates. The limitation would be reduced to $100 per capita after 1986 to reflect the sunset for small issue IDBs in that year. Rules would be provided for allocation of the limitation among State and local issuers.

Exceptions

IDBs issued to finance multifamily residential rental property would be exempt from the volume limitation. Bonds issued to benefit organizations exempt from tax under section 501(c)(3) likewise would be exempt from the limitation.

Cost recovery deductions for IDB-financed property

The Administration proposal would repeal three of the four present law exceptions to the rule requiring straight-line cost recovery deductions (over ACRS periods) for IDB-financed property. Only multifamily residential rental property would be permitted to continue to receive full accelerated cost recovery deductions.

Limitation on acquisition of land or existing facilities

The Administration proposal would eliminate the use of IDBs to purchase land or existing facilities in some cases. Interest on bonds would be tax-exempt only if no more than 25 percent of the bond proceeds were used for the purchase of land, other than farmland. A separate exception would permit IDB financing for certain farms and ranches where no more than $250,000 of IDB financing per user was outstanding and the beneficiaries of the bonds were first-time farmers or ranchers.

Tax-exempt bonds could be used to acquire an existing facility only if an amount of the bond proceeds equal to at least 15 percent of the cost of acquiring a building and equipment were used to rehabilitate the building and equipment.

Federally guaranteed bonds

The Administration proposal would deny tax exemption for obligations guaranteed, directly or indirectly, by the Federal government, including bonds issued in connection with Federal deposit insurance. Exceptions would be provided for certain housing programs and for student loan guarantees.

Non-Internal Revenue Code exemptions

Bonds issued pursuant to tax exemptions provided outside of the Internal Revenue Code generally would be required to meet the requirements of the tax-exempt bond provisions of the Code, including the restrictions applicable to industrial development bonds. The Code rules on arbitrage would be effective for bonds issued by U.S. possessions after December 20, 1983.

Arbitrage

Rules similar to the arbitrage rules applicable to mortage subsidy bonds before expiration of the tax-exemption for those bonds on December 31, 1983, would be extended to private activity bonds. These rules would apply to student loan bonds after 1984.

Other IDB provisions

Small issue IDBs would be allowed only to the extent that not more than $40 million in IDB financing was outstanding for each beneficiary of the small issue.

The volume and capital expenditure limits applicable to small issue IDBs would be applied to an entire project rather than to individual users (as under present law). The term project would be defined to include single buildings; shopping malls; and strips of offices, stores, warehouses, or residences using substantial common facilities.

The use of IDBs to finance airplanes, liquor stores, sky boxes, and gambling establishments would be prohibited.

Prior Action

The Administration proposal is similar to a committee amendment to H.R. 4170, as reported by the Committee on Ways and Means on November 16, 1983. The House of Representatives has not yet considered that bill.

An alternative proposal to limit the tax benefits available to IDB financed property is among the items to be included in the draft legislation to be prepared by February 15, 1984, for Finance Committee consideration pursuant to the Committee's resolution of November 18, 1983.

4. Tax Shelter, Accounting and Corporate Tax Reform Provisions

a. Tax shelter provisions

i. Partnership allocations

(1) Partnership allocations and distributions

Present Law

Partnership organization and syndication costs generally must be capitalized. If, instead of the partnership paying a fee for such services, the organizer is made a partner, allocation of a share of partnership income to him plus an equivalent distribution of cash may be used to defeat the capitalization requirement. Other payments to a partner that would be required to be capitalized if made to a nonpartner may similarly avoid the capitalization requirement if they are characterized as an allocation of income and an equivalent distribution.

In general, if the payment of organization or syndication costs is a guaranteed payment, it is required to be capitalized. Guaranteed payments are presently defined to include only payments made without regard to partnership income. Court cases have held that an allocation of partnership gross income is not a guaranteed payment.

Administration Proposal

Under the proposal, if a direct payment by the partnership for property or services would be chargeable to capital, distributions to a partner for such property or services would be treated the same as those made in a transaction between the partnership and one who is not a partner. Thus, those amounts would have to be capitalized. In addition, certain arrangements whereby a partner contributes property to a partnership and receives a contemporaneous distribution in respect thereof will be treated as a sale among partners or as a part sale/part contribution to the partnership.

Prior Action

A similar provision is among the items to be included in the draft legislation to be prepared by February 15, 1984, for Finance Committee consideration pursuant to the Committee's resolution of November 18, 1983.

(2) Retroactive allocations

Present Law

Items of partnership taxable income attributable to that portion of the partnership's taxable year preceding a partner's entry into the partnership generally may not be retroactively allocated to him. However, deductible expenses incurred prior to a new partner's entry into a partnership can be assigned to a new partner by the partnership's use of the cash method of accounting and deferring payment of the expenses until after the new partner's entry. Taxpayers may also manipulate allocation of deductions by the use of tiered partnerships.

Administration Proposal

Under the proposal, retroactive allocations of partnership taxable income and loss would be prevented in the case of a cash basis partnership and a tiered arrangement.

Prior Action

A similar provision is among the items to be included in the draft legislation to be prepared by February 15, 1984, for Finance Committee consideration pursuant to the Committee's resolution of November 18, 1983.

(3) Property contributed to a partnership

Present Law

Property can be contributed to a partnership and the gain or loss from its sale, or the depreciation or depletion generated by it, shifted between the partners arguably without regard to the standards that govern allocations of partnership operating income or loss generally (such as substantial economic effect). Thus, the built-in loss on contributed property may be permitted to be shifted from the contributing partner to the other partners. In addition, any depreciation or depletion from the property may be permitted to be allocated to the partners regardless of their real economic interest in the partnership.

The character of property contributed to a partnership generally depends on the relationship of the property to the partnership business. Thus, assets that were ordinary income assets (inventory and unrealized receivables) in the hands of a partner can become capital assets in the hands of a partnership. Likewise, taxpayers have argued that capital assets with built-in losses can be contributed to a dealer partnership, with the result that the losses are converted into ordinary losses, which can then be specially allocated to the partner.

Administration Proposal

Under the proposal, the rules relating to the allocation of depreciation, depletion, gains and losses on contributed property would be changed. Under these rules, any built-in gain or loss from a sale of the property would have to be allocated to the contributing partner. Depreciation and depletion would be allocated to the contributing partner and the other partners in proportion to their interests in the partnership. Thus, the elective rule in present law to allocate gain or loss and depreciation and depletion so as to take account of pre-contribution appreciation or depreciation in the property would be made mandatory, with certain minor modifications.

Built-in losses on contributed capital assets would retain their character as capital losses for five years. Property that was inventory in the hands of a contributing taxpayer would retain its character as ordinary income property for five years in the hands of the partnership. Gain from unrealized receivables contributed by a partner would constitute ordinary income to the partnership.

Prior Action

A similar provision is among the items to be included in the draft legislation to be prepared by February 15, 1984, for Finance Committee consideration pursuant to the Committee's resolution of November 18, 1983.

ii. Like-kind exchanges

Present Law

As a general rule, tax-free like-kind exchange treatment is not available for exchanges of investment assets such as stock, certificates of trust or beneficial interests, or other securities. However, case law permits an exchange of a partnership interest in one partnership for a partnership interest in another partnership to be made tax-free under certain circumstances (*Gulfstream Land and Development Co.,* 71 T.C. 587 (1979)). Thus, for example, interests in a burned out tax shelter can escape recapture in some circumstances if they can be exchanged tax-free for an interest in another partnership.

Also, case law appears to permit tax-free deferred like-kind exchanges if completed within five years. Thus, for example, an owner of property can transfer it in exchange for the right to designate a piece of like-kind property to be given for his property. If the property is received within five years the like-kind rules might apply. (*Starker v. United States,* 602 F.2d 1341 (9th Cir. 1979)).

Administration Proposal

Under the proposal, tax-free like-kind exchange treatment would be unavailable for exchanges of partnership interests in different partnerships.

In addition, gain would be recognized generally on like-kind exchanges that were not completed within 90 days after the date the taxpayer transferred the property that he relinquished in the exchange.

The proposal would apply to exchanges made pursuant to transfers made after the date of enactment.

Prior Action

A similar provision is among the items to be included in the draft legislation to be prepared by February 15, 1984, for Finance Committee consideration pursuant to the Committee's resolution of November 18, 1983.

iii. Charitable contributions

Present Law

(1) *Percentage limitation.*—Under present law, contributions of cash or ordinary-income property by an individual to public charities or to private operating foundations are deductible up to 50 percent of the donor's adjusted gross income.

(2) *Carryover.*—Contributions exceeding the applicable percentage limitation may be carried forward five years, except that generally no carryover is allowed for excess contributions to private nonoperating foundations.

(3) *Appreciated capital-gain property.*—Under present law, a contribution of a capital asset held by the donor for more than one year prior to the donation (capital-gain property) made to public charities or to private operating foundations is deductible at the asset's full fair market value at the time of the contribution, subject to a percentage limitation (30 percent of the donor's adjusted gross income) for all such contributions of capital-gain property. However, in the case of an otherwise qualifying gift of tangible personal property the use of which by the donee is unrelated to its exempt functions, the amount deductible equals the property's fair market value less 40 percent of the amount by which that value exceeds the donor's basis in the property. The deduction for gifts of ordinary-income property (such as inventory) generally is limited to the donor's basis in the property.

(4) *Overvaluation penalty.*—Present law imposes a penalty on understatements of tax that are attributable to overvaluations of property, including overstated deductions for contributions of property. The penalty does not apply with respect to property that has been held by the taxpayer for more than five years.

Administration Proposal

(1) *Percentage limitation.*—The proposal would increase, from 50 percent to 60 percent of the donor's adjusted gross income, the limitation on the deduction for contributions of cash or ordinary-income property by an individual to public charities or to private operating foundations.

(2) *Carryover.*—Under the proposal, the carryover of charitable contributions exceeding the applicable percentage limitation would be extended from five years to 15 years, and also would be made applicable to excess contributions to private nonoperating foundations.

(3) *Appreciated capital-gain property.*—Under the proposal, if the donor had not held the donated property for more than three years, the amount deductible for a charitable contribution of property (including capital-gain property) generally would be limited to the donor's cost for the property. However, in the case of a capital asset which is readily tradable on an established securities market, the full fair market value would be deductible where the donor had held the donated property for more than one year, as under present law. Contributions of property held for more than three years also would be deductible as under present law.

(4) *Overvaluation penalty.*—The proposal would apply the overvaluation penalty to all overvaluations of property without regard to the length of time the donor had held the property.

Prior Action

A similar provision is among the items to be included in draft legislation to be prepared by February 15, 1984, for Senate Finance Committee consideration pursuant to the committee's resolution of November 18, 1983.

iv. Market discount

Present Law

Any gain realized on the sale or redemption of a bond that is attributable to the difference between the redemption price and the current market price of bonds, to the extent it consists of market discount rather than original issue discount, generally results in capital gain if the bond is issued by a corporation or governmental unit and is held for more than one year. Capital gain treatment is available even if the bond appreciates in value solely because of the passage of time rather than changes in prevailing interest rates. This enables taxpayers to make leveraged purchases of market discount bonds, claiming current deductions for interest on the amount borrowed and long-term capital gain when the bond is sold or redeemed.

Administration Proposal

Under the proposal, gain on the sale or exchange of a debt instrument reflecting accrued market discount would be taxed as interest income on the disposition of the instrument. This proposal would apply to obligations issued after the date of enactment. The proposal would not apply to tax-exempt obligations.

Prior Action

A similar provision is among the items to be included in the draft legislation to be prepared by February 15, 1984, for Finance Committee consideration pursuant to the Committee's resolution of November 18, 1983.

b. Accounting reforms

i. Deferred payments

Present Law

Where there is a sale or exchange of property and a portion of the purchase price is to be paid more than one year after the date of the sale, the parties must specify a minimum (safe harbor) rate of interest to be paid by the buyer; otherwise, under section 483, interest will be imputed to the transaction at a rate specified by regulation. The safe harbor rate (currently 9 percent) is expressed in terms of simple interest. The imputed interest rate—the rate imputed to a transaction for which a rate less than the safe harbor rate has been specified by the parties—is a compound rate, applied on a semiannual basis. Both the safe harbor and imputed interest rates provided by regulation are single, fixed rates; they do not vary according to the length of time over which deferred payments are made or the maturity of the deferred payment obligation. The use of a simple interest test rate has led to numerous tax shelter transactions in which the interest component of deferred payments is understated and ACRS and ITC are overstated, sometimes substantially.

When interest is imputed under section 483, a portion of each deferred payment is characterized as interest. The allocation between interest and principal is made solely on the basis of the relative amounts of the payments, without regard to the time that has elapsed since the sale. The seller-lender and the buyer-borrower must account for interest payments using the pro rata method of reporting income or claiming a deduction, as the case may be. This may allow the purchaser in a deferred payment transaction to claim interest deductions sooner than could be claimed if interest were accrued on a constant interest basis.

Sections 1232A and 163 require that holders and issuers of certain obligations containing original issue discount (OID) accrue interest income or expense on a constant interest rate basis over the life of the obligation, regardless of the method of tax accounting normally used. These provisions, however, do not apply to any obligation issued by an individual, or (with respect to the holder) which is not a capital asset in the hands of the holder. Further, sections 1232A and 163 do not apply to obligations issued for property unless either the obligation or the property received in exchange for it is publicly traded. Failure to require that both parties to a transaction accrue interest on constant interest basis may lead to substantial tax shelter advantages.

Administration Proposal

Under the Administration proposal, section 483 would be revised so that interest rates would differ depending on the maturity of the obligation (e.g., short, medium, and long-term), and be adjusted every six months. Further, the safe-harbor interest computations would be made on a compound interest basis. The proposal also provides that imputed interest would be taken into account under the periodic inclusion rules of section 1232A (and the corresponding rule for deductions in sec. 163(e)). The maximum test rate for real estate transactions between related parties under present law would be retained. The exception to section 483 for sales of ordinary income property would be repealed.

The scope of the OID rules would be expanded to include the purchase or use of property or services for discount obligations where neither the property or services nor the obligations are publicly traded. In these cases, the amount of OID would be determined by reference to the interest rates under section 483. The capital asset limitation and the natural person exceptions to section 1232A would be repealed.

Exceptions to the expanded OID rules would be provided for transactions such as sales of farms by individuals or closely held businesses, sales of principal residences, and sales involving payments of $250,000 or less. For these excepted transactions, deductions for discount interest would not be allowed and discount income would not be recognized prior to the time of payment.

Prior Action

A similar provision is among the items to be included in the draft legislation to be prepared by February 15, 1984, for Finance Committee consideration pursuant to the Committee's resolution of November 18, 1983.

ii. Prepayments of expenses

Present Law

Under the cash method of accounting, deductions are allowed for expenditures in the year paid. Current deductions may not be claimed by an accrual method taxpayer when the expenditure produces an asset having a useful life that extends substantially beyond the close of the taxable year. Tax shelter transactions, nonetheless, have frequently employed year-end payments for expenses allocable to future time periods. Prepaid interest is treated as paid in the period to which it is allocable (i.e., cash basis taxpayers report interest as if they were on the accrual method). Under the accrual method of accounting, some taxpayers argue that certain other prepayments, such as a nonrefundable prepayment, may be deducted currently even though such prepayments may be allocable to future periods.

Administration Proposal

The Administration proposal would provide that syndicates, other than those engaged in farming, would not be allowed any deduction for prepaid expenses prior to the period to which the expenses are allocable. This rule would apply to prepayments by both cash and accrual method taxpayers. The definition of a syndicate would be similar to the definition of a farming syndicate in section 464.

Prior Action

A similar provision is among the items to be included in the draft legislation to be prepared by February 15, 1984, for Finance Committee consideration pursuant to the Committee's resolution of November 18, 1983.

iii. Interest-free loans

Present Law

Low interest and interest-free loans are currently being used to avoid long-standing tax rules that require shareholders to include dividends in income, disallow assignments of income to family members through short-term trusts, and prohibit deductions of interest for certain tax-free or tax-sheltered investments. The proper tax treatment of such loans has been the subject of extensive litigation without a comprehensive resolution of the issues.

Administration Proposal

Low interest and interest-free loans would be recharacterized as two arms-length transactions. Under this approach, the parties to a low-interest or interest-free loan would be treated as if:

(1) The lender made a loan to the debtor in exchange for a note requiring the payment of interest at a safe harbor rate;

(2) The lender (A) made a gift subject to the gift tax (in the case of a transaction between family members), or (B) paid a dividend includible in income (in the case of a transaction between a corporation and a shareholder) or compensation includible in income (in the case of a transaction between an employer and an employee or independent contractor) to fund the payment by the debtor of the interest on the loan; and

(3) The debtor paid interest on the loan at a safe harbor rate resulting in income to the lender and a deduction to the debtor.

Appropriate *de minimis* exceptions would be provided. In the case of a loan between family members, these exceptions would provide that low-interest and interest-free loans of less than $100,000 in the aggregate to a family member generally would be free of tax consequences unless the debtor has more than a *de minimis* amount of passive investment income. In a services-related context, a $10,000 cumulative *de minimis* amount would be provided. In addition, low interest insurance policy loans, bank deposits and other similar non-tax motivated commercial arrangements, loans made by sellers of property in a transaction governed by section 483, and loans bearing at least a specified minimum interest rate, would not be affected by the proposal.

Prior Action

A similar provision is among the items to be included in the draft legislation to be prepared by February 15, 1984, for Finance Committee consideration pursuant to the Committee's resolution of November 18, 1983.

iv. Related party transactions

Present Law

An accrual basis taxpayer is denied a deduction for certain accrued expenses owed to a related cash basis taxpayer unless the expense is paid within 2½ months after the close of the taxable year in which the expense is accrued. Partners and partnerships, and controlled corporations, are generally not treated as related for this purpose. Thus, deductions may be allowed without a corresponding inclusion in income for transactions between related persons. This mismatching of income and deductions has been used frequently to form the basis for tax shelter partnerships.

Administration Proposal

Related taxpayers subject to this provision would be required to defer the deduction for the accrued amount until the amount is paid.

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The definition of related party would be expanded to include partners and partnerships. The provisions also would be extended to controlled corporations.

Prior Action

In 1983, the House Ways and Means Committee reported a similar provision as part of H.R. 4170. A similar provision is among the items to be included in the draft legislation to be prepared by February 15, 1984 for Finance Committee consideration pursuant to the Committee's resolution of November 18, 1983.

v. LIFO conformity

Present Law

The "Last-In-First Out" (LIFO) method of inventory accounting may not be used for tax purposes unless it is also used in reporting to shareholders, partners, other proprietors, beneficiaries, or for credit purposes. This rule is intended to prevent businesses from taking inconsistent positions for tax and book purposes as to the method of inventory accounting that most clearly reflects income—the LIFO method, which tends to minimize income in an inflationary environment, for tax purposes, and the "FIFO" (First-In-First-Out) method, which tends to maximize income in such an environment, for financial accounting purposes.

An issue has arisen as to whether a parent company is subject to the LIFO conformity rules when the inventory is held by a subsidiary company. Under the *Insilco* case, when a subsidiary company reports to its shareholder which is a parent-holding company on a LIFO basis, the holding company may restate those inventories to a basis other than LIFO when reporting to its shareholders.

Administration Proposal

The LIFO election of subsidiaries conformity rule would be applied to a controlled group of corporations. Thus, the conformity rules would no longer be avoided through the creation of subsidiaries or holding companies. The proposal would not affect the limited exceptions to the conformity rule provided under present law (for example, for parent companies located in countries where the use of LIFO is not permitted).

Prior Action

A similar provision is among the items to be included in the draft legislation to be prepared by February 15, 1984 for Finance Committee consideration pursuant to the Committee's resolution of November 18, 1983.

vi. Premature accruals

Present Law

Under the accrual method, deductions are allowed (1) when all events have occurred which establish the fact of the liability giving rise to the deduction, and (2) the amount can be determined with reasonable accuracy (the "all-events test"). There is nothing in current law that specifically requires that an accrual method taxpayer have a current liability to pay an expense before it can be deducted. Thus, large expenditures that accrue today but that will not be paid for many years arguably are nevertheless deductible at full face value.

Permitting a deduction for an expense which is to be paid in the future overstates the expense to the extent the actual expense exceeds the present value. In the case of an expenditure that will not be paid for many years, allowing a current deduction will in effect result in the Federal Government having the entire burden of the expenditure due to the time-value of money.

Administration Proposal

The Administration proposal would clarify the "all events" test to provide that no deduction would be allowed until economic performance occurs. For example, a deduction would be permitted when services are performed, when use of property occurs and, in the case of workmen's compensation or similar liability, when the liability is satisfied. An exception to this rule would be provided for cases in which economic performance will occur within one year after the end of the taxpayer's taxable year. Exceptions to this rule would be made for transactions to which other sections apply, for example, for the deduction allowable under section 166 (relating to bad debts).

Under the proposal, the net operating loss carryback rules would be amended to allow losses to be carried back to the year in which the obligation generating the loss arose.

Prior Action

A similar provision is among the items to be included in the draft legislation to be prepared by February 15, 1984 for Finance Committee consideration pursuant to the Committee's resolution of November 18, 1983.

vii. Estimated taxes

Present Law

Under present law, an individual who fails to pay an installment of estimated income tax on or before the due date generally is subject to a penalty at the rate established for interest (under sec. 6621). The penalty is computed by applying the interest rate to the amount of the underpayment of the installment for the period of the underpayment. The amount of the underpayment is the difference between the payments (including withholding) made on or before the due date of each installment and 80 percent of the total tax shown on the return for the year divided by the number of installments that should have been made. A number of exceptions to the underpayment penalty apply. Estimated tax payments of the alternative minimum tax are not required.

Administration Proposal

Estimated tax payments of the alternative minimum tax would be required, under the same rules as are currently applicable to the estimated income payments of the regular income tax.

Prior Action

In 1983, the House Ways and Means Committee reported a similar provision as part of H.R. 4170. An identical provision was reported by the Senate Finance Committee in its budget reconciliation proposals, reported to the Senate floor as S. 2062.

viii. Straddles and other securities transactions

(1) Corporations formed to straddle

Present Law

Taxpayers may attempt to avoid the tax straddle rules by forming corporations to take positions in personal property to offset their own. Such taxpayers may seek to deduct losses despite unrecognized gains in the hands of the corporation—gains that offset the taxpayers' losses. Typically, the corporations involved are foreign, so as to defer U.S. tax on the gains.

Administration Proposal

The Administration proposal would treat stock ownership in a corporation formed or availed of to take positions in personal property that offset positions taken by shareholders as a position for the purposes of the straddle rules. This treatment would prevent a taxpayer from recognizing losses when the taxpayer uses a corporation for straddling purposes.

Prior Action

The Administration proposal is substantially similar to section 806 of H.R. 4170, the Tax Reform Act of 1983, which the House Committee on Ways and Means reported on October 20, 1983. The full House has not yet considered that bill. The proposal is also substantially similar to one provision of section 111 of S. 2062, the Omnibus Reconciliation Act of 1983, which the Senate Committee on the Budget reported on November 4, 1983 (reconciliation proposal submitted by the Senate Committee on Finance). The full Senate has not yet considered that bill.

(2) Offshore commodity funds

Present Law

Some taxpayers contend that a foreign corporation that is widely held by U.S. persons may establish a subsidiary to invest in U.S. commodities markets without any of the parties incurring U.S. tax. They argue that the accumulated earnings tax does not apply to dividends that the subsidiary pays its foreign parent on the ground that those dividends have neither a U.S. source nor a U.S. business connection. They also contend that when the U.S. shareholders eventually dispose of their shares in the foreign corporation they will be subject to tax at only the capital gain rate.

Administration Proposal

The Administration proposal would in certain cases apply the accumulated earnings tax to earnings from U.S. investments, even after those earnings pass through foreign corporate solution as dividends or interest. It would also generally treat gains of U.S. shareholders from investments in foreign corporations investing directly or indirectly in U.S. commodity markets as ordinary income.

Prior Action

The Administration proposal is substantially similar to sections 804 and 805 of H.R. 4170, the proposed Tax Reform Act of 1983, which the House Committee on Ways and Means reported on October 20, 1983. The full House has not yet considered that bill. The proposal is also substantially similar to sections 113 and 114 of S. 2062, the proposed Omnibus Reconciliation Act of 1983, which the Senate Committee on the Budget reported on November 4, 1983 (reconciliation proposal submitted by the Senate Committee on Finance). The full Senate has not yet considered that bill.

(3) Exchange-traded stock options

Present Law

Exchange-traded stock options, as well as stock, are excluded from the provisions of present law requiring deferral of losses and other limitations with respect to straddles. Because of this exemption, straddles in stock options are extensively used to defer the taxation of gain from unrelated transactions. Offsetting positions are entered, one of which results in a loss and the other an offsetting gain. The loss position is closed and replaced with a similar position to protect the offsetting gain, and the straddle as reconstituted is carried into the following year while the loss is used to shelter unrelated income from current taxation.

Administration Proposal

The proposal would subject exchange-traded stock options, and stock to the extent that it is offset by a stock option, to the loss deferral and other straddle rules of present law. The holding period of stock would not include any period for which the taxpayer has granted an in-the-money option to buy the stock. An option to buy is in the money to the extent the price at which it may be exercised is below the stock's value. An exemption would be provided for a taxpayer granting an option to buy stock which the taxpayer owns, where the option is not deep in the money as defined (a covered call option).

Prior Action

The proposal to eliminate the exemption from the straddle rules for exchange-traded options and stock offset by such options is substantially the same as the provision in section 111 of S. 2062, the

Omnibus Reconciliation Act of 1983, which the Senate Committee on the Budget reported on November 4, 1983.

(4) New options products

Present Law

Trading in options on regulated futures contracts (RFCs) commenced after the mark-to-market rules applicable to RFCs was adopted. Uncertainty as to the tax status of these new options can result in the Government being whipsawed. Those taxpayers with gains in their contracts may exercise them, acquiring an RFC position that is closed out at the favorable rates applicable to RFCs (a maximum tax rate of 32 percent for individual taxpayers). Taxpayers with losses can terminate the option through a closing transaction or allowing it to lapse, resulting in a claimed short-term capital loss.

Certain options based on indices, such as options on stock indices, are settled only in cash and it is not wholly clear that they are subject to the treatment applicable to options to buy or to sell property. Because of this uncertainty, taxpayers may claim ordinary loss and capital gain treatment with respect to these options.

Administration Proposal

Gain or loss would be recognized when a commodity option is exercised and the basis of the RFC position resulting from the exercise would be appropriately adjusted to reflect such gain or loss. Capital gain or loss from exercise of a commodity option would not be taxed under the special tax rate system applicable to RFCs.

The tax rules applicable to options would be amended to clarify that they apply to cash settlement options.

Prior Action

The proposal, as to commodity options, differs from the provision contained in section 112 of S. 2062, the Omnibus Reconciliation Act of 1983, which the Senate Committee on the Budget reported on November 4, 1983 (reconciliation proposal submitted by the Senate Committee on Finance). That provision would include options on RFCs within the definition of RFCs and tax them under the mark-to-market and tax rate system applicable to those contracts. The proposal as to cash settlement options is substantially similar to the proposal contained in section 112 of the Omnibus Reconciliation Act.

(5) Market makers in options

Present Law

Market makers and other professional options traders may defer substantial amounts of income through straddles in options. Because of the large volume of transactions, it may be difficult to identify offsetting positions and apply the loss deferral rules of present law to professional options traders. Professional traders in any event are exempt from such rules to the extent their options are entered into to hedge other positions in the normal course of business.

Administration Proposal

Under the proposal, gains and losses of professional options traders would be taxed under a mark-to-market system of accounting as if the taxpayer's options were closed at the end of the taxable year at their fair market value. The basis of options carried into the next year would be appropriately adjusted. The proposal would apply to all exchange-traded option positions of a professional options trader and to all options, whether held or written in the ordinary course of business or for investment. Those option positions entered into in the ordinary course of business would result in ordinary income or loss and those held for investment would result in capital gain or loss.

c. Corporate reforms

i. Dividends

(1) Leveraged stock investments

Present Law

Generally, a corporate shareholder may deduct at least 85 percent of the dividends it receives. Furthermore, interest paid or accrued on money borrowed by a corporation is generally fully deductible, even if the money was borrowed to buy dividend-paying stock. As a result of these rules, a corporation can borrow money to buy dividend-paying stock, deduct the interest, and also deduct 85 percent of the dividends received on that stock.

Administration Proposal

The deduction for interest paid or incurred would be appropriately limited where, but for the investment in the stock, the indebtedness would not have been incurred. The interest disallowed generally would be the amount of the dividends received deduction claimed for dividends received on the leveraged stock. The proposal would not apply with respect to dividends received from an 80-percent owned subsidiary. The proposal would apply to leveraged stock investments after the date of enactment. Appropriate transition rules would be provided for transactions in progress.

Prior Action

A similar provision is among the items to be included in the draft legislation to be prepared by February 15, 1984, for Finance Committee consideration pursuant to the Committee's resolution of November 18, 1983.

(2) Short sale transactions

Present Law

A short sale is a transaction in which an investor borrows stock (or other property), sells the stock and at a later date buys stock to repay the loan. The short seller profits if the stock declines in value between the time he sells the stock short and the time he acquires stock to repay the loan; he loses if the stock appreciates in that period. Gain or loss (usually short-term capital gain or loss in character) is measured by the difference between the amount received and the amount later paid to buy stock to return to the lender to close the short sale. As part of the transaction the taxpayer will be obligated to pay the lender an amount equal to any dividends paid on the stock in the period between the borrowing and the return. Amounts paid by the taxpayer to the lender in lieu of such dividends are deductible against ordinary income by the taxpayer (Rev. Rul. 62-42, 1962-1 C.B. 133).

As a result of these rules, a taxpayer can create short-term capital gain and an ordinary deduction in a transaction which has essentially no economic consequences. For example, a taxpayer borrows stock and sells it for $100. The stock then pays a $20 dividend, which is received by the buyer of the stock. The short seller, however, must also pay $20 to the lender of the stock in lieu of the dividend. The short seller then buys similar stock for $80 and delivers it to the lender. If the taxpayer had an otherwise unusable capital loss (capital losses are deductible only to a limited extent against ordinary income), the taxpayer could enter into such a transaction offsetting the capital loss with the gain on the short-sale and generating an ordinary deduction usable against the taxpayer's other income.

Administration Proposal

Payments in lieu of dividends (other than certain extraordinary dividends) would not be deductible against ordinary income unless the short sale is held open for at least 16 days. No deduction would be allowed for payments in lieu of extraordinary dividends (as described in proposal (3) below) unless the short sale is held open for at least 1 year and a day. The disallowed amounts paid to a lender of stock in lieu of dividends would be treated as part of the short seller's basis in the stock acquired to close the short sale, reducing the capital gain or increasing the capital loss on the short sale. A short sale would be considered as open in applying the rule only for periods during which the taxpayer is not protected against loss on the short position by holding another position. Payments in connection with short sales that are not capitalized under the proposal would be treated as interest for purposes of the rules of present law limiting the deduction of investment interest and disallowing interest on debt incurred to purchase or carry tax-exempt obligations.

Prior Action

A similar provision is among the items to be included in the draft legislation to be prepared by February 15, 1984, for Finance Committee consideration pursuant to the Committee's resolution of November 18, 1983.

(3) Extraordinary dividend

Present Law

Dividends received by a corporation generally have no effect on its basis in the stock of the distributing corporation. As a result, a corporation can buy stock for $100, receive a $15 extraordinary dividend on it, and then after satisfying a 15-day (90-day for certain preferred stock dividends) holding period requirement, sell the stock for $85. While some portion (generally 15 percent) of the $15 dividend will be taxed as ordinary income to the recipient corporation, the transaction, which has no economic consequences, will also generate $15 of short-term capital loss on the sale of the stock. This is an attractive transaction for corporations that have capital gains which can be sheltered by the loss on the sale of stock.

Administration Proposal

If the shareholder corporation does not hold stock for more than one year, the fair market value of extraordinary dividends (to the extent not subject to tax) would reduce its basis in the stock. Extraordinary dividends would include dividends received within any 90-day period with a fair market value equal to or greater than 10 percent (five percent in the case of preferred stock) of the taxpayer's basis in the stock. Extraordinary dividends would also include dividends received within any one-year period with a fair market value equal to or greater than 20 percent of the taxpayer's basis in the stock (common or preferred). The 1-year holding period (as well as the 15-day and 90-day periods under present law) would be limited to exclude any period during which the taxpayer is grantor of an in-the-money option with respect to the stock, or any period that the taxpayer's risk of loss is substantially diminished because of holding other positions. Furthermore, the shareholder corporation's holding period for dividends of property could not exceed its holding period for its stock in the distributing corporation.

Prior Action

A similar provision is among the items to be included in the draft legislation to be prepared by February 15, 1984, for Finance Committee consideration pursuant to the Committee's resolution of November 18, 1983.

(4) Ordinary nonliquidating dividend

Present Law

Generally, a distribution of appreciated property by a corporation with respect to its stock is not a taxable event to the distributing corporation, except in certain redemptions.

Administration Proposal

Any ordinary, non-liquidating, distribution of appreciated property would be taxable to the distributing corporation. Certain exceptions of present law (relating to, among other things, partial liquidations, carryover basis situations, and distributions of qualifying stock) would remain.

Prior Action

A similar provision is among the items to be included in the draft legislation to be prepared by February 15, 1984, for Finance Committee consideration pursuant to the Committee's resolution of November 18, 1983.

(5) Transfer of partnership interests by corporations

Present Law

When a partnership interest is sold, any gain is ordinary income to the extent attributable to certain ordinary income items of the partnership. When a corporation distributes property, or sells property in the course of certain complete liquidations, recapture income is taxed to the corporation while non-recapture gain attributable to appreciation in the transferred property goes unrecognized. However, it has been argued that the recapture provisions do not apply to the distribution or liquidating sale by a corporation of an interest in a partnership that holds recapture property.

Thus, taxpayers have argued that to avoid recapture, a corporation may contribute recapture property to a partnership and distribute the partnership interest to its shareholders, or sell it in the course of liquidation.

Administration Proposal

Corporate distributions and liquidating sales of partnership interests would be treated as transfers of the distributing corporation's allocable share of the partnership recapture items. Gain would be recognized to the corporation to the same extent as if the underlying partnership property were distributed or sold.

Prior Action

A similar provision is among the items to be included in the draft legislation to be prepared by Feburary 15, 1984, for Finance Committee consideration pursuant to the Committee's resolution of November 18, 1983.

ii. Investment companies and mutual funds

(1) Accumulated earnings tax

Present Law

A corporation may deduct 85 percent of the dividends it receives on portfolio stock investments. Furthermore, gain on the sale of stock held by an individual for more than one year is generally taxed as long-term capital gains at rates not in excess of 20 percent.

As a result, an investment company can be set up to be widely held by individual investors and to invest in dividend-paying stocks. The investment company itself would pay no dividends. Rather, its shareholders would hold the stock for at least a year and then sell it at a price that reflects dividends received and retained by the company. Their gains would generally be long-term capital gain, so individual shareholders would essentially be recognizing dividend income at a tax rate substantially below 50 percent. The company can avoid being treated as a regulated investment company (or "RIC") simply by not electing to be treated as a RIC. (RIC treatment would result in tax exemption at the corporate level but current taxation of the company's income to the shareholders—who would not, unless they were corporations, qualify for the 85 percent dividend received deduction.) Furthermore, relying on an interpretation of certain case law, the company may take the position that it is not subject to the accumulated earnings tax because it is widely held. Even if the investment company is subject to the accumulated earnings tax, it can substantially avoid tax by taking its capital losses and capital gains in different years since net capital losses, not deductible otherwise, are permitted as a deduction in computing the accumulated earning tax and can be used to offset the investment company's dividends that would otherwise result in imposition of the tax.

Administration Proposal

The accumulated earnings tax provisions would be amended to make clear that the mere fact that a company (whether an investment company or an operating company) is widely held will not exempt it from the accumulated earnings tax. In the above example, the company would have to pay dividends to its shareholders taxable at ordinary income rates or be subject to a penalty tax under the accumulated earnings tax provisions. The deduction for net capital losses in computing the tax would be denied to holding or investment companies. The proposal would be effective for tax years commencing after date of enactment.

Prior Action

A similar provision is among the items to be included in the draft legislation to be prepared by February 15, 1984, for Finance Committee consideration pursuant to the Committee's resolution of November 18, 1983.

(2) Capital gain dividends from mutual funds

Present Law

Regulated Investment Companies (RICs) are generally not taxed under present Law. If a RIC has a long-term capital gain, it can distribute that gain to its shareholders. Such a distribution would be treated as long-term capital gain to the shareholders. However, if a shareholder held his RIC stock for less than 31 days, any loss realized on the disposition of such stock would be treated as long-term capital loss to the extent of any long-term capital gain distribution to him. Thus, a taxpayer with short-term capital gains taxable at ordinary income rates can convert them into long-term gains taxed at preferred rates by investing in a mutual fund shortly before it is due to pay a long-term capital gain dividend. For example, a shareholder can buy RIC stock for $100, receive a long-term capital gain distribution of $10, and then sell the stock, 32 days after acquiring it, for $90. He would have $10 of long-term capital gain and $10 of short-term capital loss. Similar rules apply with respect to REITS.

Administration Proposal

All loss recognized on the sale or exchange by a shareholder of RIC or REIT stock would be long-term to the extent of long-term capital gain distributions to such shareholder with respect to such stock unless the stock is held by the shareholder for over 6 months.

Prior Action

A similar provision is among the items to be included in the draft legislation to be prepared by February 15, 1984, for Finance Committee consideration pursuant to the Committee's resolution of November 18, 1983.

iii. Collapsible corporations

Present Law

In general, a collapsible corporation is one formed or availed of principally for the manufacture, construction, production, or purchase of certain types of property with the view to the sale or exchange by the shareholders of their stock (or of the liquidation of the corporation) before the realization by the corporation of a "substantial" part of the taxable income to be derived from such property. If a stock in a collapsible corporation is sold, exchanged, or the corporation is liquidated in whole or in part (i.e., collapsed), or in the case of certain distributions, any gain recognized by any shareholder in any such sale, exchange, liquidation, or distribution which would other wise be long-term capital gain is considered ordinary income.

Under court decisions, a corporation will have realized a "substantial" part of the taxable income to be derived from the property if the corporation realizes as little as one-third of the taxable income to be derived from the property. Present law also provides an exception to collapsible corporation treatment (the "70/30" rule). In general, under this rule, if 70 percent or less of a shareholder's total gain in a taxable year is attributable to collapsible assets of the corporation, then none of the recognized gain in such year is treated as ordinary income.

Administration Proposal

Under the Administration proposal, the substantial part requirement would be defined to be "two-thirds" of the taxable income to be derived from the property.

Conforming changes will be made to the "70/30" rule to prevent corporations from otherwise avoiding the collapsible corporation provision.

Prior Action

A similar proposal was reported by the Senate Finance Committee in its budget reconciliation proposal (section 109 of S. 2062, the Omnibus Reconciliation Act of 1983, reported by the Senate Committee on the Budget, November 4, 1983). A similar, but more limited proposal, was included in H.R. 4170, the Tax Reform Act of 1983, reported by the House Committee on Ways and Means on October 21, 1983.

iv. Foreign transactions

(1) Transfers of certain assets to foreign corporations

Present Law

Certain transfers to a foreign corporation that would, under the corporate reorganization provisions of the Code, obtain tax-free treatment are taxable if the Internal Revenue Service rules that they have as one of their principal purposes the avoidance of Federal income tax (sec. 367). Under IRS guidelines, transfers of property used in the active conduct of a trade or business abroad are generally not taxable. Under those guidelines, transfers of assets containing built-in gain, such as inventory and accounts receivable, are generally subject to tax.

Judicial interpretation of the principal purpose test has eroded the ability of the IRS to administer section 367 (*e.g., Dittler Bros.* v. *Comm'r*). Also, the IRS will generally rule that the transfer to a foreign corporation of intangibles for use in connection with a foreign business is free of tax. Thus, the income from intangible property transferred overseas, the development of which generated significant U.S. deductions and credits, may escape U.S. taxation. The IRS generally requires recapture of certain losses on incorporation of a foreign branch by a U.S. person (Rev. Rul. 78-201).

Administration Proposal

The proposal would amend the rules governing transfers of property abroad to provide that gain will be recognized, without regard to purpose, upon the transfer of appreciated property to a foreign corporation which is not for use in an active trade or business outside the United States. Certain transfers of assets containing built-in gain, outlined in IRS ruling guidelines, would automatically be subject to tax. Transfers of stock would be subject to the active trade or business test. Also, transfers of intangibles for less than full consideration would be subject to tax. Finally, the proposal would codify the present IRS ruling policy on incorporations of foreign branches.

Prior Action

A similar provision is among the items to be included in the draft legislation to be prepared by February 15, 1984 for Finance Committee consideration pursuant to the Committee's resolution of November 18, 1983.

(2) Controlled foreign corporations

Present Law

When a U.S. person who is a 10-percent shareholder of a controlled foreign corporation sells or exchanges stock in a taxable transaction, some of his gain may be taxed as ordinary income, not as a capital gain (section 1248). The gain is ordinary (dividend) income to the extent of post-1962 earnings and profits attributable to such stock which were accumulated while the shareholder held the stock.

Certain transactions, however, may circumvent these rules. For instance, some have argued that where a controlled foreign corporation, that is wholly owned by a widely held U.S. corporation, exchanges its newly issued shares for shares of the U.S. corporation, that transaction may not be treated as a sale or exchange by the U.S. corporation under section 1248. If such a position were sustained, the transaction could lead to permanent exemption from U.S. corporate tax of earnings of the foreign corporation accumulated prior to the exchange. It could also have the effect of causing the foreign corporation to cease being a controlled foreign corporation for the future, thus insulating it from the anti-tax haven activity rules of the Code. Recently, in such a transaction, McDermott Incorporated became the subsidiary of its former Panamanian subsidiary.

Administration Proposal

The proposal would treat certain exchanges by a controlled foreign corporation of its newly issued stock for shares of the parent corporation as sales or exchanges by the U.S. parent of stock in the controlled foreign corporation. The proposal would apply only for purposes of section 1248. Thus, the parent could be subject to tax on some of the subsidiary's deferred earnings at ordinary income rates.

Prior Action

A similar provision is among the items to be included in the draft legislation to be prepared by February 15, 1984, for Finance Committee consideration pursuant to the Committee's resolution of November 18, 1983.

5. Institution of Withholding System—Gains Recognized by Foreign Persons on the Sale of U.S. Real Property

Present Law

Under the Foreign Investment in Real Property Tax Act of 1980, foreign persons who dispose of U.S. real property interests generally are required to pay tax on any gain recognized on the disposition. The Act provides for enforcement of the tax on foreign persons through a system of information reporting designed to identify foreign owners of U.S. real property interests.

Administration Proposal

The Administration proposal would allow replacement of the information reporting system with a withholding system. Generally, the proposal would require withholding of a certain portion of the sales price by a transferee of U.S. real estate, any agent of a transferee, or any settlement officer or transferor's agent (collectively referred to as the withholding agent) where a U.S. real property interest is acquired from a foreign person. Withholding generally would be required only if the withholding agent knew (or had received notice from the transferor or his agent) that the transferor was a foreign person. The proposal would provide for exemptions from withholding in certain cases including that in which the transferee is to use the real property as his principal residence and the purchase price is $200,000 or less.

Prior Action

The Administration proposal is the same as section 116 of S. 2062, the proposed Omnibus Reconciliation Act of 1983, which the Senate Committee on the Budget reported on November 4, 1983 (reconciliation proposal submitted by the Senate Committee on Finance). The full Senate has not yet considered that bill. This proposal's provisions are similar to provisions that passed the Senate in 1980, 1981, and 1982; in each instance, a House-Senate conference agreement did not adopt those provisions.

B. Revenue Reduction Items

1. Enterprise Zones

Present Law

Under present law, certain restrictions relating to industrial development bonds and mortgage subsidy bonds are relaxed in economically distressed areas. In addition, certain domestic corporations deriving income from Puerto Rico and possessions of the United States are eligible for a tax credit that eliminates U.S. tax on that income.

Administration Proposal

The Administration proposes that beginning in 1984 up to 25 small areas per year (not to exceed 75 in total) be designated "enterprise zones." Effective January 1, 1985, the following tax incentives would be available for economic activity in the zones: an exemption from tax of capital gains on certain qualified property, a tax credit for employees equal to 5 percent of the first $10,500 of wages earned, a tax credit for employers equal to 10 percent of any increases in their payrolls (up to $1,750 per employee), a separate tax credit for employers of certain disadvantaged individuals equal to 50 percent of the wages of such persons for the first three years of employment (the percentage declines by 10 points in the fourth year and each year thereafter), an increase of 50 percent in the regular investment tax credit for investment in equipment, a 10-percent investment tax credit for new construction and reconstruction of buildings, and continued availability of tax-exempt bond financing beyond the 1986 sunset date for small issue bonds. These incentives generally would remain fully in effect for 20 years and would be phased out over the succeeding four years. (An enterprise zone could be designated for a period of less than 20 years.)

Prior Action

The Administration proposed a similar provision as part of its fiscal year 1984 budget. In May 1983, the Senate Committee on Finance approved an amendment, similar to the Administration proposal, which was included in the Finance Committee amendment to H.R. 2973, as passed by the Senate on June 16, 1983. The Senate amendment to H.R. 2973 relating to enterprise zone tax incentives was deleted in conference on the bill.

Also, the House Committee on Ways and Means held a hearing on November 17, 1983, on the Administration proposal (contained in H.R. 1955).[1]

2. Tuition Tax Credits

Present Law

Present law does not provide any tax credit or deduction for personal educational expenses. However, in certain circumstances, job-related educational expenses may be deducted as ordinary and necessary business expenses.

Administration Proposal

The Administration proposal would provide a nonrefundable income tax credit equal to 50 percent of certain tuition expenses paid to private elementary and secondary schools for qualified dependents of the taxpayer, subject to a dollar limitation. The credit would apply to tuition payments made after July 31, 1984. The maximum credit would be $100 in 1984, $200 in 1985, and $300 in 1986 and subsequent years. Additionally, the maximum credit would be "phased down" for taxpayers with adjusted gross incomes greater than $40,000, with no credit being allowed to a taxpayer with an adjusted gross income in excess of $60,000.

No credit would be allowed for payments to any school that follows a racially discriminatory policy. A new declaratory judgment procedure would be enacted under which the Attorney General could bring action to determine whether a school follows a racially discriminatory policy.

Prior Action

The Administration proposed a similar credit for tuition expenses as part of its Fiscal Year 1984 budget.

The Senate Committee on Finance reported a bill, S. 528 (S. Rep. 98-154, June 20, 1983), containing provisions similar to the Administration proposal. In 1983, the Senate considered, but did not adopt, the provisions of S. 528 as an amendment in the nature of a substitute to H.J. Res. 290.

3. Education Savings Accounts

Present Law

Under present law, there is no specific provision that permits deductions for amounts contributed by an individual to a trust to pay education expenses of the individual or a child of the individual or for the exclusion of income from assets in such a trust. However, certain types of "job-related" education expenses may be deducted by an individual as ordinary and necessary business expenses.

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[1] For a description of H.R. 1955, see Joint Committee on Taxation staff pamphlet, "Description of Bills (H.R. 1955, H.R. 1735, and H.R. 2375) Relating to Distressed Area Tax Incentives," JCS-58-83, Nov. 15, 1983.

Administration Proposal

The Administration proposal would create a permanent tax exclusion for all interest and dividends earned on amounts deposited by parents in qualified education savings accounts, provided the deposits are used for eligible education expenses of their children. No deductions would be permitted for contributions to the account. If amounts are withdrawn from the account and not applied to eligible education expenses, the tax otherwise due on the earnings would be recaptured and a penalty tax generally would be imposed.

In general, eligible education expenses would include tuition and room and board incurred on behalf of a full-time student for post-secondary education. However, amounts paid to schools that follow a racially discriminatory policy would not be treated as eligible expenses. Certain reporting obligations would be imposed on the financial institutions maintaining the accounts and the colleges or universities receiving withdrawals from such accounts.

Deposits to these accounts would be subject to a number of limitations. First, under the proposal, the maximum annual contribution to a qualified education savings account would be $1,000 per child. However, the $1,000 limit would be reduced by 5 percent of the amount by which the taxpayer's adjusted gross income exceeds $40,000. Thus, no contribution could be made by a taxpayer whose adjusted gross income exceeds $60,000. Second, no contribution could be made on behalf of a child over the age of 18, and in no case could an account be maintained after the beginning of the taxable year in which a child attains age 26.

Prior Action

A substantially similar proposal was included in the Administration's 1984 budget.

4. Women's Equity Provisions

a. Increase in spousal IRA limit

Present Law

An individual generally is entitled to deduct from gross income the amount contributed to an individual retirement account or annuity (IRA) for a taxable year, not in excess of the lesser of $2,000 or 100 percent of compensation. If deductible contributions are made (1) to an individual's IRA and (2) to an IRA for the noncompensated spouse of the individual, then the annual deduction limit on the couple's joint return is increased to $2,250 (or 100 percent of the individual's compensation, if less), but no more than $2,000 may be deducted for a contribution to the IRA of either spouse.

Administration Proposal

The proposal would provide that, for purposes of the IRA deduction limits, the compensation of an individual is the sum of (1) the individual's compensation and (2) the compensation of the individual's spouse, reduced by the deductible IRA contributions made by the individual's spouse. Under the proposal, for example, if one spouse has compensation of at least $4,000 and the other spouse has no compensation for a year, each spouse could contribute up to $2,000 to IRAs and the couple would be entitled to an IRA deduction of $4,000 on a joint return for the year.

Prior Action

A bill (S. 888) containing a provision substantially similar to the Administration's proposal was included in hearings before the Senate Finance Committee on June 20-21, 1983,[2] but was not formally considered by the Committee prior to adjournment. Several bills (H.R. 2984, H.R. 3266, H.R. 3307, and H.R. 3309) containing provisions substantially similar to the Administration's proposal were included in hearings before the Ways and Means Committee on October 25-26, 1983,[3] but were not formally considered by the Committee prior to adjournment.

b. IRA deduction limit—alimony as compensation

Present Law

An individual generally is entitled to deduct from gross income the amount contributed to an individual retirement account or annuity (IRA) for a taxable year, not in excess of the lesser of $2,000 or 100 percent of compensation. Under present law, in limited cases, alimony received by a divorced spouse can be taken into account under the IRA deduction limits. If the requirements of the Code are met, then the IRA deduction limit is not less than the lesser of (1) $1,125 or (2) the sum of the individual's compensation and certain alimony includible in the individual's gross income for the year. Alimony taken into account under this rule does not reduce the IRA deduction limit of the individual paying the alimony.

Administration Proposal

The proposal would expand the IRA deduction rules so that alimony generally would be treated as compensation of the recipient. As under present law, alimony taken into account under this rule would not reduce the IRA deduction limit of the individual paying the alimony.

Prior Action

A bill (S. 888) containing a provision substantially similar to the Administration's proposal was included in hearings before the Senate Finance Committee on June 20-21, 1983,[4] but was not formally considered by the Committee prior to adjournment. Two bills (H.R. 2090 and H.R. 2099) containing provisions substantially similar to the Administration's proposal were included in hearings

[2] For a description of S. 888, see Joint Committee on Taxation staff pamphlet, "Description of S. 19 (Retirement Equity Act of 1983) and S. 888 (Economic Equity Act of 1983)," JCS-26-83, June 16, 1983.

[3] For a description of the provisions of these bills, see Joint Committee on Taxation staff pamphlet, "Description of Bills Relating to Economic Equality in Various Tax, Pension, and Related Federal Laws," JCS-50-83, Oct. 21, 1983.

[4] See footnote 2, *supra*.

before the Ways and Means Committee on October 25–26, 1983,[5] but were not formally considered by the Committee prior to adjournment.

c. Nonprofit dependent care facilities—tax exempt status

Present Law

Under present law, organizations that are organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes and that meet certain other requirements are exempt from Federal income tax. The Internal Revenue Service generally takes the position that an organization that is organized and operated exclusively to provide care to children in order to allow a parent of a child to be gainfully employed is not an educational organization because its principal activity is not to provide education to children, but to provide day care facilities for the benefit of the parents.

Administration Proposal

The proposal would provide that a dependent care organization is organized for educational purposes and, therefore, may be tax exempt if (1) the organization is organized and operated to provide nonresidential dependent care of individuals, (2) substantially all of the dependent care is provided by the organization to enable individuals to be gainfully employed, and (3) the services provided by the organization are available to the general public.

Prior Action

A bill (S. 888) containing a provision substantially similar to the Administration's proposal was included in hearings before the Senate Finance Committee on June 20–21, 1983,[6] but was not formally considered by the Committee prior to adjournment. Several bills (H.R. 1603, H.R. 1991, and H.R. 2090) containing provisions substantially similar to the Administration's proposal were included in hearings before the Ways and Means Committee on October 25–26, 1983,[7] but were not formally considered by the Committee prior to adjournment.

d. Increase in dependent care tax credit

Present Law

Present law provides a nonrefundable tax credit for a portion of employment-related dependent care expenses paid by an individual who maintains a household that includes one or more qualifying individuals. The maximum credit is equal to 30 percent of employment-related expenses (up to a maximum of $2,400, if there is one qualifying individual, and $4,800, if there are two or more qualifying individuals) of individuals with $10,000 or less of adjusted gross income. Accordingly, the maximum credit is $720 if there is one

[5] See footnote 3, *supra*.
[6] See footnote 2, *supra*.
[7] See footnote 3, *supra*.

qualifying individual or $1,440 if there are two or more qualifying individuals. The maximum 30-percent credit rate is reduced (but not below 20 percent) by one percentage point for each $2,000 (or fraction thereof) of adjusted gross income above $10,000.

Administration Proposal

The proposal would increase the rate of the credit for employment-related dependent care expenses to 40 percent for an individual with adjusted gross income of less than $11,000. This percentage would decrease as income increases, so that the rate of the credit would be zero for individuals with adjusted gross income of $60,000 or more.

5. Tax Exemption for U.S. Military and Civilian Government Personnel Killed in Action Overseas

Present Law

Under present law, the Federal income tax does not apply to the income of military personnel who die while serving in a combat zone, or as a result of wounds, disease, or injury incurred while serving in a combat zone, for the year of death and for any prior year ending on or after the first day of service in a combat zone. Similar tax treatment was provided for any members of the crew of the U.S.S. Pueblo who died while being illegally detained by the Democratic People's Republic of Korea, and for any American hostage held captive in Iran who died as a result of injury or disease or physical or mental disability incurred or aggravated while in captive status.

Administration Proposal

Under the Administration proposal, the Federal income tax would not apply to the income of any active member of the U.S. Armed Forces or any civilian employee of the U.S. Government who dies as a result of wounds or injury incurred (after 1979) outside the United States in a terroristic or military action, for taxable years beginning with the year before the year in which the injuries occurred, and ending with the year of death.

The term terroristic or military action would be defined to mean any terroristic activity directed against the United States or any of its allies, or any military action (not including training exercises) involving U.S. Armed Forces and resulting from violence or aggression against the United States or any of its allies (or the threat of such violence or aggression). The term allies of the United States would include any multinational force in which the United States is participating.

Prior Action

In 1983, the House Committee on Ways and Means approved a similar provision to be included in a committee amendment to H.R. 4170 as reported by the committee. A similar provision is among the items to be included in draft legislation to be prepared by February 15, 1984, for Senate Finance Committee consideration pursuant to the committee's resolution of November 18, 1983.

6. Extension of Expiring Provisions

a. Extension of the credit for research and experimental expenditures

Present Law

General rule

The Economic Recovery Tax Act of 1981 enacted an income tax credit for certain qualified research expenditures incurred in carrying on a trade or business. The credit applies only to the extent that the taxpayer's qualified research expenditures for the taxable year exceed the average amount of yearly qualified research expenditures in the specified base period (generally, the preceding three taxable years). The rate of the credit is 25 percent of the incremental research expenditure amount.

Under present law, the credit will not apply to research expenditures after December 31, 1985.

Qualifying expenditures

A taxpayer's research expenditures eligible for the incremental credit consist of (1) "in-house" expenditures by the taxpayer for research wages and supplies used in research, plus certain amounts paid for research use of laboratory equipment, computers, or other personal property; (2) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf; and (3) if the taxpayer is a corporation, 65 percent of the taxpayer's expenditures (including grants or contributions) pursuant to a written research agreement for basic research to be performed by universities or certain scientific research organizations.

The definition of research for purposes of the credit is the same as that used for purposes of the special deduction rules in Code section 174, but subject to certain exclusions. Treasury regulations under section 174 define research to mean "research and development costs in the experimental or laboratory sense." This includes generally "all such costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property," and also the costs of obtaining a patent on such property.

The present section 174 regulations provide that qualifying research expenditures do not include expenditures "such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising, or promotions." Also, the section 174 deduction is not available for the costs of acquiring another person's patent, model, production, or process or to research expenditures incurred in connection with literary, historical, or similar projects.

Administration Proposal

The Administration proposal would extend for three years (i.e., for expenditures through December 31, 1988) the credit for increased research expenditures. In addition, the definition of research expenditures would be modified so that only qualifying expenditures incurred in the development of new or significantly improved products or processes would be eligible for the credit.

Prior Action

In 1983, the Senate Finance Subcommittee on Taxation and Debt Management held a hearing on legislation (S. 738, S. 1194, and S. 1195) which would make permanent, and modify in certain respects, the credit for increased research expenditures.[8]

b. Extension of moratorium on application of existing research and experimental allocation regulations

Present Law

All taxable income has either a U.S. source or a foreign source. The foreign tax credit can offset tax on foreign-source taxable income, but not on U.S.-source taxable income. A shift in the source of income from foreign to U.S. may increase U.S. tax by reducing the foreign taxes that a taxpayer may credit. In determining foreign-source taxable income, taxpayers must divide expenses between gross foreign-source income and gross U.S.-source income (Code secs. 861–863). Detailed rules for allocating and apportioning research and other expenses are set forth in Treasury regulations under Code section 861. Under these regulations, some of a taxpayer's research expenses may reduce its foreign-source income.

In the Economic Recovery Tax Act of 1981 (ERTA), the Congress directed the Treasury Department to study the impact of its section 861 regulations on research activities conducted in the United States and on the availability of the foreign tax credit. Pending action on the study, the Congress provided that for a taxpayer's first two taxable years beginning after the date of enactment of ERTA (August 13, 1981), all expenditures for research activities conducted in the United States would reduce U.S.-source income.

Administration Proposal

The Administration proposal would provide a two-year extension of the rule which allocates to U.S. sources all research expenditures attributable to activities conducted in the United States.

Prior Action

On June 14, 1983, the Secretary of the Treasury submitted the report required by ERTA on the impact of the section 1.861–8 regulations on domestic research and development. The report recommended that the moratorium on this regulation be continued for two additional years.

[8] For a description of these bills, see Joint Committee on Taxation pamphlet, "Description of Tax Bills (S. 654, S. 738, S. 1147, S. 1194, and S. 1195)," JCS-18-83, May 26, 1983.

The Subcommittee on Oversight of the House Committee on Ways and Means held hearings on the subject on October 26 and November 3, 1983.[9] On November 9, 1983, the Oversight Subcommittee issued a report concerning the allocation of research expenditures between U.S. and foreign income. That report recommended a five-year extension of ERTA's temporary allocation solely to U.S. sources, and suggested further Treasury study of that temporary allocation and of the desirability of limiting tax-free transfers of intangibles to foreign corporations. The Committee on Ways and Means has not acted on that recommendation.

c. Extension of targeted jobs tax credit

Present Law

The targeted jobs tax credit, which applies to wages paid to eligible individuals who begin work for the employer before January 1, 1985, is available on an elective basis for hiring individuals from one or more of 9 target groups. The target groups are (1) vocational rehabilitation referrals; (2) economically disadvantaged youths aged 18 through 24, (3) economically disadvantaged Vietnam-era veterans; (4) Supplemental Security Income (SSI) recipients; (5) general assistance recipients; (6) economically disadvantaged cooperative education students aged 16 through 19; (7) economically disadvantaged former convicts; (8) AFDC recipients and WIN registrants; and (9) disadvantaged youths aged 16 or 17 for summer employment.

The credit generally is equal to 50 percent of the first $6,000 of qualified first-year wages and 25 percent of qualified second-year wages paid to a member of a targeted group. Thus, the maximum credit is $3,000 per individual in the first year of employment and $1,500 per individual in the second year of employment. With respect to summer youth employment, however, the credit is 85 percent of up to $3,000 of wages, for a maximum credit of $2,550. The employer's deduction for wages must be reduced by the amount of the credit.

Administration Proposal

The credit would be extended to apply to eligible individuals who begin work for the employer before January 1, 1986.

d. Extension of payment-in-kind (PIK) program

Present Law

The Department of Agriculture conducted a program for the 1983 crop year under which payments in kind were made to producers who withdrew land from production of wheat, corn, grain sorghum, cotton, and rice. This program has been extended for the 1984 crop year for wheat only.

The Payment-in-Kind Tax Act of 1983 provided that commodities received under the 1983 PIK program are treated as if they were

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[9] See Joint Committee on Taxation pamphlet, "Background and Issues Relating to Research and Experimentation Expense Source Allocation Rules," JCS-49-83, Oct. 20, 1983.

grown on the land withdrawn from production under the PIK program, and that such land is treated as if used in an active farming operation. These provisions also apply to wheat that would have been planted in 1983 and harvested in 1984, but for participation in a 1984 PIK program.

Administration Proposal

The Administration proposal would extend the special tax rules enacted for the 1983 PIK program to spring wheat that would have been both planted and harvested in 1984, but for participation in the 1984 wheat PIK program.

Prior Action

A similar provision to the Administration proposal is included in a committee amendment to H.R. 4170 as reported by the Committee on Ways and Means during the First Session of the 98th Congress. The House of Representatives has not yet considered that bill.

7. Taxation of Life Insurance Companies and Products

Present Law

Corporate tax

Under present law, a life insurance company is taxed on the lesser of its taxable investment income or its gain from operations. If a company's gain from operations exceeds its taxable investment income, the company is taxed on 50 percent of the excess. The tax with respect to the other half of the excess is deferred. That half (along with amounts deducted for nonparticipating contracts, and accident and health and group life insurance contracts) is added to a deferred tax account (policyholders' surplus account) and, subject to certain limitations, is taxed only when distributed to shareholders of a stock company. Thus, a life insurance company must compute its gain (or loss) from operations and its taxable investment income. The computation of gain from operations begins with the company's total income including the company's share of investment yield, net capital gain, premiums and other considerations, decreases in insurance reserves, and all other amounts. From this total, a life insurance company is allowed deductions. These generally include the usual deductions available to taxpayers for business or investment expenses, and operations loss deduction, and certain deductions unique to the insurance business such as for payments of claims and death benefits, for increases in reserves (to the extent not funded out of the policyholders' share of investment income), and for certain payments under assumption reinsurance. All life insurance companies are also permitted to claim a small business deduction. Finally, there are three special deductions for policyholder dividends, nonparticipating contracts, and accident and health and group life insurance contracts, which are subject to limitations. Unlike the deduction for policyholder dividends, the other two special deductions do not reflect actual cash expenditures by the company or even the commitment of funds to a reserve required under State law.

Life insurance products

Generally, present law does not tax a policyholder on the investment earnings of a life insurance or annuity contract unless that income is withdrawn from the contract. There is no generally applicable definition of a life insurance contract under present law.

Withdrawals (including loans) from a deferred annuity contract prior to age 59½ generally are subject to a penalty equal to 5 percent of the income withdrawn. An exception is provided for withdrawals of income attributable to investments made at least 10 years prior to the withdrawal.

Interest on loans from life insurance contracts generally is deductible by the policyholder unless the debt is incurred to purchase or carry a single premium contract or carry a life insurance contract.

The value of up to $50,000 of group-term life insurance coverage provided to an employee on a nondiscriminatory basis is excluded from the employee's income under present law. The $50,000 limitation and nondiscrimination rules do not apply to coverage for a retired employee.

Administration Proposal

Corporate tax

The Administration proposes that, starting in 1984, life insurance companies be taxed under a single-phase system, on their life insurance company taxable (LICTI). Generally, LICTI is a life insurance company's gross income reduced by (1) deductions that are generally the same as those available to other taxpayers; (2) deductions for reserves computed using Federally prescribed methods; (3) a small company deduction equal to 60 percent of the first $3 million of tentative LICTI (phasing out at $15 million), and (4) a special life insurance company deduction equal to 20 percent of tentative LICTI (after any small company deduction). The policyholder dividend and reserve deductions of a mutual life insurance company would be reduced to reflect an amount earned for the policyholders as owners of the company. Under the proposal, the 50-percent deferral, the reserve revaluations, and the present-law special deductions for nonparticipating contracts and accident and health and group life insurance contracts would be eliminated.

Life insurance products

The Administration also proposes a comprehensive tax definition of life insurance contracts. Under this proposal, the earnings on certain investment-oriented policies would no longer qualify for the deferral available under present law.

With respect to annuities, the proposal would repeal the 10-year investment exception to the 5-percent penalty on premature withdrawals from annuity contracts. In addition, when an annuity holder dies prior to annuitization, the proposal would impose limitations on the period following death over which deferral of the annuity income could continue.

The Administration proposes a strengthening of the limitations on policyholder loan deductions.

Finally, the Administration proposes extending the $50,000 limitation on, and the nondiscrimination rules for, the group-term life insurance exclusion to retired employees.

Prior Action

A substantially similar proposal was reported by the House Committee on Ways and Means in the first session of the 98th Congress (H.R. 4170 as reported; H. Rep. No. 98-432, October 21, 1982), but has not been considered by the House. S. 1992, which contains life insurance provisions identical to those in H.R. 4170, is pending before the Senate Committee on Finance. Hearings on the policyholder provisions of the Senate bill were held on January 31, 1984. The current legislative proposals respond to the need for legislation brought about by the expiration at the end of 1983 of temporary life insurance tax provisions enacted in 1982. On December 20, 1983, the Treasury announced that during 1984 and prior to Congressional action on the definition of life insurance, no new rulings or technical advices will be issued on the definition of life insurance.

The Administration proposals differ from H.R. 4170 and S. 1992 in three significant ways. First, the Administration proposes a 20-percent special life insurance company deduction rather than the 25-percent deduction provided for in the bills. Second, the Administration does not propose a rule requiring the income on deferred annuities to be taxed to the decedent immediately at death. Third, the Administration proposes somewhat stronger limits on deductions of interest on policyholder loans than those in H.R. 4170 and S. 1992.

C. Other Revenue Items

1. Replacement of DISC System of Tax Deferral

Present Law

Present law provides a system of tax deferral for Domestic International Sales Corporations (DISC) and their shareholders. A DISC is typically a domestic subsidiary of a U.S. company engaged in exporting. The income attributable to exports may be apportioned between the parent and the DISC using special pricing rules instead of the arm's-length method. The shareholders of the DISC are taxed when profits are distributed or deemed distributed. Each year a portion of the DISC's income is deemed distributed; tax on the remaining income is deferred until the income is actually distributed. To qualify as a DISC at least 95 percent of the corporation's assets must be export-related and at least 95 percent of the receipts must be from exports.

Several countries have alleged that DISC is an export subsidy that violates the General Agreement on Tariffs and Trade (GATT).

Administration Proposal

The Administration proposal would provide for the establishment of foreign sales corporations (FSCs) which typically would be foreign incorporated subsidiaries of U.S. parent corporations engaged in exporting. To qualify as a FSC, a corporation would have to be organized under the laws of a jurisdiction outside the U.S. customs area and meet certain foreign presence requirements.

The tax rules of the proposal would apply to the export income of a FSC if it were managed outside the United States and if some economic processes of the transaction took place outside the United States. In addition, the proposal would apply to the export income of a small FSC attributable to up to $2,500,000 of export receipts whether or not its management or economic processes were foreign.

Under administrative pricing rules, the FSC generally would earn the greater of 23 percent of the taxable income that it and its related party derive from an export transaction or 1.83 percent of the gross receipts from the transaction.

The proposal would exempt a portion of the export income of a FSC from U.S. tax. If a transaction were subject to one of the administrative transfer pricing rules, this exempt portion would be 17/23 of the FSC's income from the transaction. The rest of export income (including generally 6/23 of the FSC's income) would be subject to U.S. tax. Dividends from export income paid by a FSC to a U.S. corporate shareholder would be tax-exempt at the corporate shareholder level.

The prosposal would provide tax deferral under the present DISC rules for up to $10 million of export receipts but would require those companies to pay interest on the deferred tax. Also, income from trade receivables of a related party would be passive income subject to the anti-incorporated pocketbook and anti-tax haven rules. In addition, the proposal would treat accumulated DISC income as having been previously taxed, so that tax on those amounts would be forgiven.

Prior Action

The proposal was recommended by the Administration in 1983 and was introduced in 1983 in the Senate as S. 1804 and in the House as H.R. 3810.

The Senate Finance Committee held a hearing on the proposal on November 18, 1983.[10] A second hearing is scheduled for February 3, 1984.

2. Trust for Investments in Mortgages

Present Law

Under present law, a grantor trust is an arrangement under which legal title to property is transferred to a trustee with the transferor retaining certain powers over, or interests in, the trust. As a result of these retained powers or interests, the grantor is treated for Federal tax purposes as the owner of the property. Thus, income, deductions, and credits of the grantor trust are attributed directly to the grantor and no tax is imposed at the entity level.

Arrangements have been made for the sale of mortgages in the secondary mortgage market through the sale of interests in pools of mortgages. Under many of these arrangements, mortgages are transferred to a trust with interests in the trust offered to investors. Under present law, the IRS takes the position that a mortgage pool only qualifies as a grantor trust for tax purposes and is not subject to an entity level tax, if the trustee has no power to vary the investments of the trust such as by reinvestment of regular installments of interest or early recoveries of principal or interest. In addition, there is uncertainty whether the beneficial interests in a trust can differ as to amount as well as to kind.

Other entities such as partnerships, S corporations, and real estate investment trusts can also be used as conduits for Federal tax purposes and can hold assets for investors without being subject to an entity level tax. Restrictions on the use of these entities, however, make them generally less advantageous for purposes of holding mortgages and issuing securities to investors.

At the present time, the secondary market is dominated by three agencies with ties to the Federal government; the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC), and the Government National Mortgage Association (GNMA).

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[10] For a detailed description of the provisions of S. 1804, see Joint Committee on Taxation staff pamphlet, "Replacement of Domestic International Sales Corporations (DISCs): Description of S. 1804 (Foreign Sales Corporation Act)," JCS-61-83, Nov. 17, 1983.

Administration Proposal

A "trust for investment in mortgages" (TIM) would be a corporation or trust that would hold mortgages and issue securities to investors. A TIM would be a pass-through entity: the shareholders of a TIM would be taxed on its income and no tax generally would be levied on the TIM. A TIM would be able to issue more than one class of transferable shares. Further, the trustees of a TIM would have certain discretion to manage the TIM's assets. Under the proposal, FNMA, FHLMC and GNMA would be denied direct or indirect access to TIMs.

Prior Action

On November 4, 1983, the Finance Committee held a public hearing on S. 1822,[11] a similar proposal introduced by Senators Garn and Tower.

3. Cafeteria Plans

Present Law

Under a cafeteria plan that meets the requirements of section 125, an employee may be given a choice of cash, taxable benefits (e.g., vacation days, group-term life insurance in excess of $50,000), and nontaxable benefits (e.g., group-term life insurance up to $50,000, group legal services, accident and health benefits). Employer contributions under such a plan are excluded from an employee's gross income to the extent that nontaxable benefits are elected.

Administration Proposal

The proposal would provide that a cafeteria plan may offer employees choices only among cash or those fringe benefits (other than scholarships or fellowships, educational assistance, and vanpooling) that are excludable from gross income under a specific section of the Internal Revenue Code.

Under the proposal, group-term life insurance that is includible in gross income only because the amount of the insurance exceeds $50,000 would be treated as a nontaxable benefit. Similarly, vacation days that cannot be cashed out in a later year would be treated as a nontaxable benefit.

Prior Action

Title V of H.R. 4170, reported by the House Ways and Means Committee on October 20, 1983, contains a provision substantially similar to the Administration's proposal. The full House has not yet considered that bill.

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[11] For a description of S. 1822, see Joint Committee on Taxation staff pamphlet, "Description of S. 1822 (Relating to Trusts for Investments in Mortgages)," JCS-55-83, Nov. 3, 1983.

D. Treasury Tax Structure Study

Administration Study

The Treasury Department has been directed by the President to conduct a tax structure study during 1984, and to develop a comprehensive plan to reform and simplify the entire Federal Tax Code so that all taxpayers are treated more fairly. Objectives of the tax reform include improved compliance and a broader tax base so that tax rates can be lowered. A set of specific recommendations based on the study and consistent with these objectives is to be presented to the President in December 1984.

IV. TREASURY'S ESTIMATED REVENUE EFFECTS OF ADMINISTRATION'S REVENUE PROPOSALS

Fiscal Years, 1985–87

[Billions of dollars]

Item	1985	1986	1987	1985–87
A. Revenue increases:				
1. Health insurance cap	3.9	6.5	8.0	18.3
2. Tax-exempt leasing	1.7	2.7	4.0	8.4
3. Private purpose tax-exempt bonds	.2	.4	.8	1.4
4. Tax shelter provisions	.5	1.3	1.1	2.9
5. Accounting abuses	2.5	2.3	2.8	7.5
6. Corporate reforms	.2	.7	.9	1.8
7. Institution of withholding system—gains recognized by foreign person on the sale of U.S. real property	.1	[1]	[1]	.1
Total, revenue increases	**9.1**	**13.9**	**17.4**	**40.4**
B. Revenue reductions:				
1. Enterprise zones	−.1	−.4	−.8	−1.3
2. Tuition tax credits	−.3	−.6	−.9	−1.8
3. Education savings accounts	[2]	−.1	−.3	−.5
4. Increase in spousal IRA limit	−.3	−.7	−.8	−1.8
5. IRA deduction limit—taxable alimony as compensation	[2]	[2]	[2]	[2]
6. Nonprofit dependent care facilities—tax-exempt status	[2]	[2]	[2]	[2]
7. Increase in dependent care tax credit	[2]	−.1	−.1	−.3
8. Tax exemption for military personnel killed in action overseas				
9. Extension of credit for research and experimental expenditures		−.4	−.7	−1.1
10. Extension of moratorium on application of existing research and experimental allocation regulations	−.1	−.1		−.2

Fiscal Years, 1985-87—Continued

[Billions of dollars]

Item	1985	1986	1987	1985-87
11. Extension of targeted job tax credit	−.2	−.4	−.4	−.9
12. Extension of payment-in-kind program	(2)	(1)	....	(1)
13. Life insurance company taxation	−.8	−.9	−1.0	−2.8
Total, revenue reductions	**−1.9**	**−3.8**	**−5.0**	**−10.6**
C. Other items:				
1. Replacement of DISC system of tax deferral	(2)	(2)	.1	(2)
2. Trusts for investment in mortgages	(2)	(2)	(2)	(2)
3. Cafeteria plans	(1)	(1)	(1)	(1)
Total, other items	(2)	(2)	.1	(2)
D. Additional items affecting budget receipts [3]	.7	1.5	1.6	3.9
Grand total, all proposals	**7.8**	**11.6**	**14.1**	**33.5**

[1] Gain of less than $50,000,000.
[2] Loss of less than $50,000,000.
[3] Of these additional items, those having the most significant effect on budget receipts are proposals to provide for changes in contributions to civil service retirement and to extend Federal/State unemployment insurance coverage to railroad retirement.

Note.—Details may not add to totals due to rounding.

Source: Estimates provided by the Office of the Secretary of the Treasury.

APPENDIX: ADDITIONAL REVENUE TABLES

Table A-1.—Budget Receipts by Source, Fiscal Years 1983–89 [1]

[Billions of dollars]

Source	1983 actual	Estimate					
		1984	1985	1986	1987	1988	1989
Individual income taxes	288.9	293.3	328.4	364.1	401.6	447.3	490.7
Corporation income taxes	37.0	66.6	76.5	87.9	97.9	103.9	107.9
Social insurance taxes and contributions	209.0	239.5	270.7	297.8	324.1	362.2	394.8
Excise taxes	35.3	38.2	38.4	34.1	33.4	33.9	34.5
Estate & gift taxes	6.1	5.9	5.6	5.1	4.6	4.3	4.7
Customs duties	8.7	9.1	9.4	9.6	9.9	10.3	11.1
Miscellaneous receipts	15.6	17.5	16.0	16.3	16.3	16.3	16.6
Total, budget receipts	600.6	670.1	745.1	814.9	887.8	978.3	1,060.3

[1] Estimates assume adoption of administration's revenue proposals.

Source: Budget of the United States, Fiscal Year 1985.

Table A-2.—The Effect on Fiscal Year Receipts of the Economic Recovery Tax Act of 1981, 1982–89 [1]

[Millions of dollars]

Item	1982	1983	1984	1985	1986	1987	1988	1989
Individual income tax reductions:								
General rate reductions	−25,315	−57,717	−87,531	−99,543	−112,439	−127,277	−143,496	−160,449
Top marginal rate	−1,101	−2,179	−1,188	−845	−1,056	−1,320	−1,650	−2,063
Deduction for two-earner married couples	−320	−3,122	−6,199	−6,633	−7,184	−8,074	−9,075	−10,164
Indexing				−5,073	−14,390	−25,447	−38,548	−52,860
Child and dependent care credit and dependent care assistance exclusion	−26	−217	−260	−309	−375	−433	−484	−539
Charitable contributions deduction for nonitemizers	−16	−122	−162	−498	−1,850	−2,939		
Rollover and exclusion of gain from sale of residence	−48	−105	−116	−127	−140	−154	−169	−186
Foreign earned income	−299	−544	−563	−618	−696	−784	−872	−998
Total, individual	−27,125	−64,006	−96,019	−113,646	−138,130	−166,428	−194,294	−227,259
Capital cost recovery provisions:								
Accelerated cost recovery system	−9,596	−17,807	−26,117	−35,121	−48,669	−58,812	−62,472	−63,568
Used property limitation for ITC	−115	−74	−85	−137	−195	−209	−243	−262
Other provisions	−309	−43	−36	12	31	17	−45	−48
Total, capital cost recovery	−10,020	−17,924	−26,238	−35,246	−48,833	−59,004	−62,760	−63,878
Rehabilitation expenditure provisions	−132	−208	−239	−302	−409	−579	−793	−1,039
Incentives for research and development:								
Tax credit for research and experimentation	−391	−576	−704	−706	−420	−86	−30	−8
Other provisions	−57	−120	−62					
Total, research and development	−448	−696	−766	−706	−420	−86	−30	−8
Small business provisions:								
Accumulated earnings credit and subchapter S rules	−18	−53	−63	−73	−85	−99	−101	−103

Table A-2.—The Effect on Fiscal Year Receipts of the Economic Recovery Tax Act of 1981, 1982–89 [1]—Continued

[Millions of dollars]

Item	1982	1983	1984	1985	1986	1987	1988	1989
LIFO inventory and small business accounting	−68	−184	−192	−145	−64	−72	−74	−80
Total, small business	−86	−237	−255	−218	−149	−171	−175	−183
Windfall profit tax and other energy provisions	−728	−515	−488	−474	−343	−289	−283	−275
Corporate rate reductions and other business provisions:								
Corporate tax rate reductions	−79	−258	−329	−413	−441	−461	−482	−497
Other provisions	−165	−84	−14	74	163	206	233	254
Total, corporate rates and other business	−244	−342	−343	−339	−278	−255	−249	−243
Savings incentives provisions:								
Keogh plans	−56	−157	−173	−183	−201	−221	−243	−270
Extend IRA eligibility to qualified plan participants	−2,286	−6,137	−6,379	−6,951	−7,763	−8,472	−9,099	−9,949
Increased IRA deduction for individuals not participating in qualified plans	−232	−610	−617	−670	−748	−818	−882	−967
Partial dividend and interest exclusion	407	1,616		−941	−2,919	−3,271	−3,664	−4,102
Tax-exempt savings certificates	−296	−1,224	−320					
ESOPs		−61	−618	−1,611	−2,186	−2,383	−2,626	−2,865
Dividend reinvestment plans	−130	−365	−416	−449	−278	(2)	(2)	(2)
Total, savings incentives	−2,593	−6,938	−8,523	−10,805	−14,095	−15,165	−16,514	−18,153

Estate and gift provisions	−114	−2,411	−3,703	−4,941	−6,548	−8,124	−9,631	−10,514
Tax straddles	627	942	1,015	1,134	1,303	1,279	1,538	1,909
Administrative provisions	809	1,193	1,704	659	456	591	809	752
Miscellaneous provisions	−134	63	243	−81	−300	−308	−320	−343
Grand total, all revenue provisions	**−40,188**	**−91,079**	**−133,612**	**−164,965**	**−207,746**	**−248,539**	−282,702	−319,234

[1] Does not show detail of fiscal year 1981 revenue effects, which totalled −$335 million.
[2] Less than $5 million.

Source: U.S. Department of the Treasury.

Table A-3.—The Effect on Fiscal Year Receipts of the Tax Equity and Fiscal Responsibility Act of 1982, 1983–89 [1]

[Millions of dollars]

Item	1983	1984	1985	1986	1987	1988	1989
Individual provisions:							
Individual minimum tax	(2)	686	788	892	979	1,074	1,251
Deductions for medical expenses	268	1,773	1,729	1,901	2,089	2,296	2,523
Deductions for casualty losses	(2)	667	737	818	908	1,008	1,119
Total, individual	268	3,126	3,254	3,611	3,976	4,378	4,893
Business provisions:							
Business tax preferences	381	534	584	588	626	684	743
Basis adjustment for investment tax credit	362	1,377	2,721	4,177	5,642	6,869	7,721
Limitation on investment tax credit	152	259	213	178	164	151	177
ACRS			1,451	9,618	17,155	17,246	13,726
Construction period interest and taxes	555	1,179	1,206	1,084	820	538	409
Leasing	1,036	2,425	4,101	5,350	6,860	8,528	9,831
Foreign oil and gas	200	438	508	569	621	672	727
Possessions and Virgin Island Corporations	233	492	526	586	654	728	810
Tax-exempt bonds	36	284	579	809	1,155	1,536	1,955
Mergers and acquisitions	427	749	959	1,014	1,065	1,083	1,101
Accounting for long-term contracts	882	2,235	2,535	2,390	2,559	2,741	2,936
Accelerated corporate payments	1,039	4,449	564	762	654	242	99
Original issue discount and strips	163	310	465	629	808	1,017	1,281
Total, business	5,466	14,731	16,412	27,754	38,873	42,035	41,517

Compliance provisions:							
Withholding on dividends and interest	134	2,888	3,143	3,483	3,848	4,157	4,506
Other compliance	1,382	2,282	3,322	4,319	4,751	5,056	5,432
Additional IRS personnel	2,100	2,400	2,400	1,300	600		
Total, compliance	3,616	7,570	8,865	9,102	9,199	9,213	9,938
Pension provisions	194	780	870	972	1,059	1,157	1,268
Insurance provisions	2,003	2,148	2,773	3,064	3,397	3,766	4,175
Employment tax provisions:							
Independent contractors	−117	−107	−79	−85	−92	−97	−108
Federal unemployment tax	1,470	2,308	2,280	1,847	1,466	1,253	1,071
Extend medicare tax to Federal employees	657	893	958	1,086	1,181	1,265	1,355
Lower unemployment insurance taxable threshold	691	741	580	524	498	465	430
Total, employment tax	2,701	3,835	3,739	3,372	3,053	2,886	2,748
Excise tax provisions:							
Airport and airway taxes	711	813	930	1,023	1,277	−939	−1,774
Cigarette tax increase	1,197	1,829	1,859	−34	−13		
Telephone tax increase	564	987	1,452	658			
Repeal TAPS adjustment	49	23	16	19			
Total, excise tax	2,521	3,652	4,257	1,666	1,264	−939	−1,774

Table A-3.—The Effect on Fiscal Year Receipts of the Tax Equity and Fiscal Responsibility Act of 1982, 1983–89 [1]—Continued

[Millions of dollars]

Item	1983	1984	1985	1986	1987	1988	1989
Extension of targeted jobs credit	−122	−370	−396	−182	−36	−3	....
Other provisions	−38	−37	−34	−32	−30	−30	−30
Total revenue effect	**16,609**	**35,435**	**39,740**	**49,237**	**60,665**	**62,463**	**62,735**
Outlays: Computation of interest on refunds	649	636	443	379	374	361	351
Total budget effect of revenue provisions	**17,258**	**36,071**	**40,183**	**49,706**	**61,039**	**62,824**	**63,086**

[1] Does not show detail of fiscal year 1982 revenue effects, which totalled $4 million.
[2] Less than $500,000.

Source: U.S. Department of Treasury.

Table A-4.—The Effect on Fiscal Year Receipts of the Social Security Amendments of 1983, 1984–89

[Millions of dollars]

	1984	1985	1986	1987	1988	1989
Prohibit State and local withdrawal	87	311	564	818	1,107	1,418
Include all nonprofit institutions	1,435	2,398	2,896	3,366	3,920	4,505
Include new Federal employees	64	181	346	556	765	971
Accelerate 1985 FICA/RRTA tax rate increase to 1984:						
Increase in rate	6,542	2,402				
Employee tax credit	−3,311	−1,213				
Total	3,231	1,189				
Increase FICA/RRTA tax rate to 6.06 percent on Jan. 1, 1988					10,963	15,921
Reduction in income tax receipts associated with increases in employer contributions	−1,027	−418	−355	−413	−1,855	−2,238
Increase SECA tax rate:						
Rate increase	1,427	4,257	4,237	4,555	5,068	5,950
Tax credit	−829	−2,427	−2,198	−2,120	−2,232	−2,372
Total	598	1,830	2,039	2,435	2,836	3,578
Tax 50 percent of social security and tier 1 railroad benefits	980	3,303	3,919	4,661	5,534	6,557
Employment taxation of retirement arrangements	133	224	273	329	396	476
Tax credit for the elderly and disabled	1	4	6	7	9	11
State and local government deposit schedule	747	54	56	62	67	73

Table A-4.—The Effect on Fiscal Year Receipts of the Social Security Amendments of 1983, 1984-89—Continued

[Millions of dollars]

	1984	1985	1986	1987	1988	1989
Interest on unemployment compensation funds:						
Unemployment trust fund taxes	−74	−259	−461	−457	−358	−250
Interest [1]	−272	−230	167	186	151	84
Other provisions	22	31	33	35	37	40
Grand total	**6,197**	**8,848**	**9,316**	**11,399**	**23,421**	**31,062**

[1] The proposal is effective for 1983. The reduction in interest received in 1983 is $82 million.