[JOINT COMMITTEE PRINT]

DESCRIPTION OF TAX PROVISIONS EXPIRING IN 1990

PREPARED BY THE STAFF

OF THE

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CONTENTS

INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a brief description of tax provisions scheduled to expire in 1990, including a reference to the legislative background of each provision and any related Administration budget proposal.[2]

The first part of the pamphlet is a summary listing of tax provisions scheduled to expire in 1990. The second part is a description of the expiring provisions: (A) expiring income tax provisions; (B) expiring excise tax provisions; and (C) other expiring provisions. The Appendix presents the estimated revenue effects for fiscal years 1991-1995 of permanently extending the expiring provisions.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of Tax Provisions Expiring in 1990* (JCS-5-90), February 21, 1990.

[2] Several of the expiring tax provisions are also described in Joint Committee on Taxation, *Summary of Revenue Provisions in the President's Fiscal Year 1991 Budget Proposal* (JCS-3-90), February 5, 1990.

I. SUMMARY

The following is a summary listing of tax provisions scheduled to expire in 1990.

Expiring income tax provisions

The following income tax provisions are scheduled to expire in 1990: [3]

(1) Exclusion for employer-provided educational assistance benefits (Code sec. 127);

(2) Exclusion for group legal services benefits and the tax exemption for an organization providing group legal services as part of a qualified group legal services plan (secs. 120 and 501(c)(20));

(3) Deduction for health insurance costs of self-employed individuals (sec. 162(l));

(4) Tax exemption for qualified mortgage bonds and election to issue mortgage credit certificates (secs. 143 and 25);

(5) Tax exemption for qualified small-issue manufacturing bonds (sec. 144(a));

(6) Rules for allocation and apportionment of research expenses (secs. 861(b), 862(b), 863(b), and 864(f));

(7) Tax credit for qualified research expenditures (sec. 41);

(8) Tax credit for low-income rental housing (sec. 42);

(9) Targeted jobs tax credit (sec. 51);

(10) Business energy tax credits for solar, geothermal, and ocean thermal property (secs. 46(a)(2) and 46(b)(2)(A));

(11) Placed-in-service date for the production credit for nonconventional fuels (sec. 29); and

(12) Tax credit for orphan drug clinical testing expenses (sec. 28).

Expiring excise tax provisions

The following excise tax provisions are scheduled to expire in 1990: [4]

(1) Airport and Airway Trust Fund excise taxes—air passenger ticket tax (sec. 4261), international departure tax (sec. 4261(c)), air cargo tax (sec. 4271), and taxes on noncommercial (general) aviation fuels (secs. 4041(c), 4081, and 4091);

(2) Excise tax on communications (telephone) services (sec. 4251); and

(3) Excise tax on deep seabed hard minerals (sec. 4495).

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[3] The income tax provisions, *except* for items (11) and (12), were last extended in the Revenue Reconciliation Act of 1989 (Title VII of the Omnibus Budget Reconciliation Act of 1989, P.L. 101-239).

[4] Although not scheduled to expire until the end of 1991, the 0.1 cent per gallon fuels excise taxes for the Leaking Underground Storage Tank Trust Fund (secs. 4081(a)(2)(B)(ii), 4041(d), 4091, and 4042) are projected by the Treasury Department to reach the $500 million revenue cap in August 1990; the taxes therefore will be terminated on the last day of August, unless Congress raises the revenue cap (see sec. 4081(d)(2)).

Other expiring provisions

The following other revenue provisions are also scheduled to expire in 1990:

(1) Limitations on grant administrative expenses for private foundations (sec. 4942(g)(4));

(2) IRS user fees (sec. 10511 of the Omnibus Budget Reconciliation Act of 1987); and

(3) Federal unemployment tax (FUTA) 0.2-percent surtax (sec. 3301).

II. DESCRIPTION OF EXPIRING TAX PROVISIONS

A. Expiring Income Tax Provisions

1. Exclusion for employer-provided educational assistance (sec. 127 of the Code)

Present Law

Under present law, an employee generally must include in income and wages, for income and employment tax purposes, the value of educational assistance provided by an employer to the employee, unless the cost of such assistance qualifies as a deductible job-related expense of the employee. Amounts expended for education qualify as deductible job-related expenses if the education (1) maintains or improves skills required for the employee's current job, or (2) meets the express requirements of the individual's employer that are imposed as a condition of continued employment (Treas. Reg. sec. 1.162-5(a)). In the case of an employee, such expenses (if not reimbursed by the employer) are deductible only to the extent that, when aggregated with other miscellaneous itemized deductions, they exceed 2 percent of the taxpayer's adjusted gross income. No deduction is allowed for expenses incurred to qualify for a new trade or business (e.g., for law school tuition paid by a paralegal or accountant).

Under present law, an employee's gross income and wages for income and employment tax purposes do not include amounts paid or incurred by the employer for educational assistance provided to the employee if such amounts are paid or incurred pursuant to an educational assistance program that meets certain requirements (sec. 127). One such requirement is that the educational assistance provided may not discriminate in favor of highly compensated employees in certain respects. This exclusion, which expires for taxable years beginning after September 30, 1990, is limited to $5,250 of educational assistance with respect to an individual during a calendar year. Only amounts paid before October 1, 1990, in a taxable year beginning in 1990 are taken into account in determining the amount of the exclusion for such taxable year.

The exclusion for educational assistance benefits does not apply to graduate level courses. Specifically, the exclusion does not apply to any payment for, or the provision of any benefits with respect to, any course taken by an employee who has a bachelor's degree or is receiving credit toward a more advanced degree, if the particular course can be taken for credit by any individual in a program leading to a law, business, medical, or other advanced academic or professional degree.

To the extent that employer-provided educational assistance is not excludable from income because it exceeds the maximum dollar limitation or because of the limitation on graduate-level courses, it may be excludable from income as a working condition fringe benefit (sec. 132(d)), provided the requirements of that section are otherwise satisfied (e.g., the education is job related as defined under sec. 162).

In 1984, the Congress required that employers file information returns with respect to educational assistance programs (sec. 6039D). This requirement was intended to collect data with respect to the use of such programs so that the Congress could evaluate the effectiveness of the exclusion.

Legislative Background

The section 127 exclusion was first established on a temporary basis by the Revenue Act of 1978 (through 1983). It subsequently was extended, again on a temporary basis, by Public Law 98-611 (through 1985), by the Tax Reform Act of 1986 (through 1987), by the Technical and Miscellaneous Revenue Act of 1988 (through 1988), and by the Omnibus Budget Reconciliation Act of 1989 (through September 30, 1990). Public Law 98-611 adopted a $5,000 annual limit on the exclusion; this limit was subsequently raised to $5,250 in the Tax Reform Act of 1986. The Technical and Miscellaneous Revenue Act of 1988 made the exclusion inapplicable to graduate-level courses.

2. Exclusion for employer-provided group legal services; tax exemption for qualified group legal services organizations (secs. 120 and 501(c)(20) of the Code)

Present Law

Under present law, amounts contributed by an employer to a qualified group legal services plan for an employee (or the employee's spouse or dependents) are excluded from the employee's gross income for income and employment tax purposes (sec. 120). The exclusion also applies to any services received by an employee (or the employee's spouse or dependents) or any amounts paid to an employee under such a plan as reimbursement for the cost of legal services for the employee (or the employee's spouse or dependents). The exclusion is limited to an annual premium value of $70. In order to be a plan under which employees are entitled to tax-free benefits, a group legal services plan is required to fulfill certain requirements. One such requirement is that group legal services benefits may not discriminate in favor of highly compensated employees in certain respects.

The exclusion for group legal services benefits expires for taxable years beginning after September 30, 1990. Only amounts paid before October 1, 1990, in taxable years beginning in 1990 for coverage before October 1, 1990, are taken into account in determining the amount of the exclusion for the year.

In addition, present law provides tax-exempt status for an organization the exclusive function of which is to provide legal services or indemnification against the cost of legal services as part of a qualified group legal services plan (sec. 501(c)(20)). The tax exemption for such an organization expires for taxable years beginning after September 30, 1990.

In 1984, the Congress required that employers file information returns with respect to qualified group legal services plans (sec. 6039D). This requirement was intended to collect data with respect to the use of such plans so that the Congress could evaluate the effectiveness of the exclusion.

Legislative Background

The section 120 exclusion and the section 501(c)(20) exemption were enacted initially on a temporary basis by the Tax Reform Act of 1976 (through 1981). They subsequently were extended, again on a temporary basis, by the Economic Recovery Act of 1981 (through 1984), Public Law 98-612 (through 1985), the Tax Reform Act of 1986 (through 1987), the Technical and Miscellaneous Revenue Act of 1988 (through 1988), and the Omnibus Budget Reconciliation Act of 1989 (through September 30, 1990). The Technical and Miscellaneous Revenue Act of 1988 adopted the $70 annual premium limit.

3. Deduction for health insurance costs of self-employed individuals (sec. 162(l) of the Code)

Present Law

Under present law, an employer's contribution to a plan providing accident or health coverage is excludable from an employee's income (sec. 106). No equivalent exclusion is provided for self-employed individuals (i.e., sole proprietors or partners in a partnership).

However, present law provides a deduction for 25 percent of the amounts paid for health insurance for a taxable year on behalf of a self-employed individual and the individual's spouse and dependents. This deduction is allowable in calculating adjusted gross income. A self-employed individual is an individual who has earned income for the taxable year (sec. 401(c)(1)). No deduction is allowable to the extent the deduction exceeds the self-employed individual's earned income for the taxable year.

The 25-percent deduction is also available to a more than 2-percent shareholder of an S corporation. For purposes of the deduction, the shareholder's wages from the S corporation are treated as his or her earned income. In addition, the Secretary is authorized to prescribe necessary adjustments relating to the application of the deduction in the case of S corporation shareholders.

No deduction is allowable for any taxable year in which the self-employed individual or eligible S corporation shareholder is eligible to participate (on a subsidized basis) in a health plan of an employer of the self-employed individual (or of such individual's spouse).

The amount deductible under this provision is not taken into account in computing net earnings from self-employment (sec. 1402(a)). Therefore, the amounts deductible under this provision do not reduce the income base for the self-employed individual's social security tax.

The 25-percent deduction expires for taxable years beginning after September 30, 1990. For taxable years beginning in 1990, the deduction is allowed only for premiums paid for coverage before October 1, 1990. In addition, an individual's earned income for the taxable year beginning in 1990 is pro rated in determining the applicable deduction for such year.

Legislative Background

The 25-percent deduction for the health insurance costs of self-employed individuals was enacted on a temporary basis by the Tax Reform Act of 1986 (for taxable years beginning before January 1, 1990). Certain technical corrections to the provision were made by the Technical and Miscellaneous Revenue Act of 1988. The Omnibus Budget Reconciliation Act of 1989 extended the deduction for 9 months (for taxable years beginning before October 1, 1990) and clarified that the deduction is available to certain S corporation shareholders.

Administration Budget Proposal

The President's fiscal year 1991 budget proposal would make permanent the 25-percent deduction for health insurance costs of self-employed individuals.

4. Qualified mortgage bonds and mortgage credit certificates (secs. 143 and 25 of the Code)

Present Law

Qualified mortgage bonds

In general, mortgage revenue bonds qualifying for tax-exemption under section 103 of the Code ("qualified mortgage bonds") are bonds the proceeds of which are used (net of costs of issuance and a reasonably required reserve fund) to finance the purchase, or qualifying rehabilitation or improvement, of single-family, owner-occupied homes located within the jurisdiction of the issuer of the bonds.

First-time homebuyer requirement

An issue is a qualified mortgage issue only if at least 95 percent of the net proceeds of the issue are used to finance residences for mortgagors without present ownership interests in their principal residences during the three-year period before their respective mortgages are executed. This first-time homebuyer requirement does not apply to mortgagors of residences located in targeted areas (as described below), mortgagors who receive qualified home improvement loans, or mortgagors who receive qualified rehabilitation loans.

Income limitations

Qualified mortgage bond financing is available only to mortgagors whose family incomes do not exceed 115 percent (100 percent for families of fewer than three persons) of the higher of (1) the median gross income for the area in which the residence is located, or (2) the Statewide median gross income.

An adjustment to the mortgagor's qualifying income limitation is made for high housing cost areas. For purposes of this provision, the applicable income limit for the mortgagor will be the highest of 115 percent (100 percent for families of fewer than three persons) of area median gross income, the adjusted income limit determined for high housing cost areas, or 115 percent (100 percent for families of fewer than three persons) of the State median gross income. Family income of mortgagors (as well as area median gross income) is to be determined by the Treasury Department after taking into account the regulations under section 8 of the United States Housing Act of 1937.

In targeted areas, two-thirds of the mortgage financing provided with the proceeds of each issue must be provided to mortgagors who have family incomes not exceeding 140 percent (120 percent for families of fewer than three persons) of the higher of (1) the median gross income for the area in which the residence is located, or (2) the Statewide median gross income. The remaining one-third of the mortgage financing of each issue may be used to provide mortgage loans without regard to income limitations. A targeted area is defined as (1) a census tract in which at least 70 percent of the families have incomes that are 80 percent or less of the Statewide median family income, or (2) an area of chronic economic distress designated by the Secretary of the Treasury and the Secretary of Housing and Urban Development.

Purchase price limitations

The acquisition cost of a residence financed with qualified mortgage bonds may not exceed 90 percent (110 percent in targeted areas) of the average area purchase price applicable to the residence. The determination of average area purchase prices is made separately (1) with respect to new residences and existing, previously occupied residences, and (2) to the extent provided in regulations, with respect to one-, two-, three-, and four-family residences.

Loan origination and loan prepayment rules

All unspent proceeds remaining 3 years after the date of issuance of qualified mortgage revenue bonds must be used to redeem bonds within the next six months. The amount of any loans originated during that 6-month period will reduce the amount of bonds to be redeemed by the amount of such loans. Generally, the amounts of regular loan repayments and prepayments which are received ten years or more after the date the bonds are issued must be used to redeem bonds. A *de minimis* exemption of $250,000 is allowed from these redemption requirements. Repayments received during the 10-year period following original issuance may be used to make new loans.

Recapture

All or part of the subsidy provided by qualified mortgage revenue bond financing or mortgage credit certificates (described below) is recaptured on dispositions of assisted housing which occur within 10 years of purchase by mortgagors whose incomes increased substantially since purchase of their homes. The maximum amount recaptured is 1.25 percent of the original balance of the loan for each year the loan is outstanding, or 50 percent of the gain realized on the disposition, whichever is less. For sales in years six through 10, the 1.25 percent per year is phased out. This recapture provision only applies to loans originated, and mortgage credit certificates issued, after December 31, 1990.

Mortgage credit certificates

Qualified governmental units may elect to exchange qualified mortgage bond authority for authority to issue mortgage credit certificates (MCCs) (sec. 25). MCCs entitle homebuyers to nonrefundable income tax credits for a specified percentage of interest paid on mortgage loans on their principal residences. Once issued, an MCC remains in effect as long as the residence being financed continues to be the certificate-recipient's principal residence. MCCs are generally subject to the same eligibility and targeted area requirements as qualified mortgage bonds.

Each MCC must represent a credit for 10 to 50 percent of interest on qualifying mortgage indebtedness. The actual dollar amount of an MCC depends on the amount of qualifying interest paid during any particular year and the applicable certificate credit percentage. If the credit percentage exceeds 20 percent, however, the dollar amount of the credit received by the taxpayer for any year may not exceed $2,000.

The aggregate amount of MCCs distributed by an electing issuer may not exceed 25 percent of the volume of qualified mortgage bond authority exchanged by the State or local government for authority to issue MCCs. For example, a State that is authorized to issue $200 million of qualified mortgage bonds and that elects to exchange $100 million of that bond authority can distribute an aggregate amount of MCCs equal to $25 million.

Legislative Background

The Mortgage Subsidy Bond Act of 1980 imposed restrictions on the ability of State and local governments to issue tax-exempt bonds to finance mortgage loans on single-family, owner-occupied residences. The 1980 Act provided that interest on mortgage subsidy bonds would be exempt from taxation only if the bonds were "qualified veterans' mortgage bonds" or "qualified mortgage bonds."

The authority of State and local governments to issue tax-exempt qualified mortgage bonds under the 1980 Act expired on December 31, 1983. The Deficit Reduction Act of 1984 extended this authority (with modifications) through December 31, 1987.

The authority to issue qualified mortgage bonds and the election to trade in bond volume authority to issue MCCs were extended for one year, (through December 31, 1988) by the Tax Reform Act of 1986, and for another year, (through December 31, 1989) by the Technical and Miscellaneous Revenue Act of 1988. The Omnibus Budget Reconciliation of 1989 extended the sunset date for issues of mortgage revenue bonds and trade-ins of bond volume authority for 9 months (through September 30, 1990).

26-862 0 - 90 - 2

5. Qualified small-issue manufacturing bonds (sec. 144(a) of the Code)

Present Law

Interest on certain small issues of private activity bonds is exempt from tax if at least 95 percent of the bond proceeds is used to finance manufacturing facilities or certain land or property for first-time farmers ("qualified small-issue bonds").

Qualified small-issue bonds are issues having an aggregate authorized face amount (including certain outstanding prior issues) of $1 million or less. Special limits apply to bonds for first-time farmers. Alternatively, the aggregate face amount of the issue, together with the aggregate amount of certain related capital expenditures during the 6-year period beginning three years before the date of the issue and ending three years after that date, may not exceed $10 million. In determining whether an issue meets the requirements of the small-issue exception, previous small issues (and in the case of the $10-million limitation, capital expenditures during a 6-year period) are taken into account if (1) they are used with respect to a facility located in the same incorporated municipality or the same county (but not in any incorporated municipality) as the facility being financed with the qualified small-issue bonds, and (2) the principal users of both facilities are either the same person, or are two or more related persons.

The aggregate amount of qualified small-issue bond financing for all types of depreciable farm property (including both new and used property) is limited to $250,000 for any person or related persons. The $250,000 is a lifetime limit.

Capital expenditures not included for purposes of the $10 million limit are expenditures (1) made to replace property destroyed or damaged by fire, storm, or other casualty; (2) required by a change in Federal, State, or local law made after the date of issue; (3) subject to a $1 million limit, required by circumstances that reasonably could not be foreseen on the date of issue; or (4) qualifying as in-house research expenses (excluding research in the social sciences or humanities and research funded by outside grants or contracts).

Interest on qualified small-issue bonds is taxable if the aggregate face amount of all outstanding tax-exempt private activity bonds (including exempt-facility bonds, qualified redevelopment bonds, and qualified small-issue bonds) that would be allocated to any beneficiary (other than a section 501(c)(3) organization) of the qualified small-issue bonds exceeds $40 million. Bonds that are to be redeemed with the proceeds of a new issue (other than in an advance refunding) are not considered. Certain current refunding bonds are also not taken into account.

For purposes of the $40 million limitation, the face amount of any issue is allocated among persons who are owners or principal users of the bond-financed property during a 3-year test period. This may result in all or part of a facility being allocated to more than one person, as when one person owns bond-financed property and other persons are principal users, or when owners and/or principal users change during the 3-year test period. Once an allocation to a test-period beneficiary is made, that allocation remains in effect as long as the bonds are outstanding, even if the beneficiary no longer owns or uses the bond-financed property. If the $40 million limit is exceeded for any owner or principal user as a result of a change during the test period, interest on the issue of qualified small-issue bonds that caused the limit to be exceeded is taxable from the date of issue. The tax-exempt status of interest on other previously issued qualified small-issue bonds is not affected.

To be a qualified bond, the issuer must receive an allocation from the State private activity volume limitation. Authority to issue qualified small-issue bonds expires September 30, 1990.

Legislative Background

Substantial modifications to the tax treatment of exempt small-issue industrial development bonds (IDBs) were made by the Tax Equity and Fiscal Responsibility Act of 1982. The 1982 Act also provided that the authority to issue exempt small-issue IDBs would sunset after December 31, 1986. The Deficit Reduction Act of 1984 extended the sunset date for issues of qualified small-issue bonds for manufacturing facilities to December 31, 1988. The Tax Reform Act of 1986 extended that sunset date to December 31, 1989.

The Technical and Miscellaneous Revenue Act of 1988 clarified the definition of manufacturing to provide that up to 25 percent of the proceeds of a qualified small issue may be used to finance ancillary activities which are carried out at the manufacturing site. The Omnibus Budget Reconciliation Act of 1989 extended the sunset date for issues of qualified small-issue bonds for manufacturing facilities to September 30, 1990.

6. Allocation and apportionment of research expenses (secs. 861(b), 862(b), 863(b), and 864(f) of the Code)

Present Law [5]

In general

U.S. persons are taxable on their worldwide income, including their foreign income. A U.S. person that earns foreign income may incur foreign income tax. Subject to the applicable foreign tax credit limitations, such a person may credit foreign income taxes against its U.S. tax liability. The purpose of the foreign tax credit and the foreign tax credit limitations is to yield primary taxing jurisdiction over U.S. persons' foreign income to foreign governments, while retaining residual taxing jurisdiction over such income for the United States and ensuring that the full U.S. tax is paid on domestic income.

The foreign tax credit limitations operate by separating the taxpayer's total U.S. tax liability before tax credits ("pre-credit U.S. tax") into 2 categories: tax on U.S. source taxable income and tax on foreign source taxable income. Pre-credit U.S. tax on foreign

[5] Some of the provisions discussed in this section were described more comprehensively in Part III of the April 2, 1987 pamphlet, prepared by the staff of the Joint Committee on Taxation for the Senate Committee on Finance, entitled *Description of Proposals Relating to Research and Development Incentive Act of 1987 (S. 58) and Allocation of R&D Expenses to U.S. and Foreign Income (S. 716)* (JCS-6-87).

source taxable income is further subdivided by limitation categories, or "baskets," of income. The pre-credit U.S. tax on any particular limitation category of foreign source income serves as the upper limit on credits for foreign taxes on that type of income.

Each foreign tax credit limitation equals total pre-credit U.S. tax times the ratio of the taxable income in that limitation category to worldwide taxable income. Foreign source taxable income equals foreign source gross income less the expenses, losses, and other deductions properly apportioned or allocated thereto, and a ratable part of any deductions which cannot definitely be allocated to some item or class of gross income (Code sec. 862(b)). Deductions allocated and apportioned to foreign source gross income must be further allocated or apportioned among the separate limitation categories of foreign source gross income in order to arrive at foreign source taxable income in any one limitation category. Finally, allocation and apportionment of deductions to U.S. source gross income determines the amount of taxpayer's U.S. source taxable income (sec. 861(b)).

The Code generally articulates only the broad principles of how expenses reduce U.S. and foreign source gross income, leaving the Treasury Department to provide detailed rules for the generally fact-specific task of allocating and apportioning expenses. The application of regulations to particular facts and circumstances, therefore, has a significant role in determining the proportions of taxpayers' worldwide taxable income that are treated as derived from foreign sources. These proportions control, in turn, the level of taxpayers' foreign tax credit limitations.

A taxpayer that has paid less foreign tax in each limitation category than the foreign tax credit limitation with respect to that category credits all of its foreign income tax against pre-credit U.S. tax (such a taxpayer is said to have "excess limit" in each of its limitation categories). If the rules for allocating and apportioning deductions are then changed to permit foreign source deductions to be converted to U.S. source deductions, with the result that a greater proportion of the taxpayer's worldwide taxable income is deemed to come from foreign sources, the change cannot decrease the taxpayer's U.S. tax liability on its worldwide income. A taxpayer that has paid foreign taxes in excess of one or more of its foreign tax credit limitations (that is, a taxpayer with "excess credits") cannot currently use all of its foreign income taxes as credits. In this case, a change in the allocation and apportionment rules may result in additional use of foreign tax credits, as follows: The conversion of a foreign source deduction to a U.S. source deduction converts an amount of U.S. source taxable income to foreign source taxable income, thus increasing the foreign tax credit limitation and reducing the taxpayer's current U.S. tax liability by approximately 34 cents for each dollar of deduction that is converted from foreign to U.S. source. Conversely, upon a change in the allocation rules that shifts deductions from U.S. to foreign income, a taxpayer with excess credits (or a taxpayer that previously had excess limit and finds itself, as a result of the rule change, with excess credits) may experience an increase in U.S. tax liability due to a reduction in the amount of its foreign income taxes that remain creditable, thereby increasing its overall worldwide tax liability.

Treasury Regulation sec. 1.861-8(e)(3)

Treasury Regulations promulgated in 1977 prescribe detailed rules for allocating and apportioning research and experimental expenses for purposes of computing the foreign tax credit limitation of a U.S. person, as well as for other purposes (Treas. Reg. sec. 1.861-8(e)(3)).[6]

This R&D allocation regulation contemplates that taxpayers will sometimes undertake R&D solely to meet legal requirements. In some such cases, the R&D cannot reasonably be expected to generate income (beyond *de minimis* amounts) outside a single geographic source. If so, those deductible R&D expenses reduce gross income only from the geographic source that includes that jurisdiction.

After allocating deductions to meet legal requirements, the regulation generally allows 30 percent of deductible R&D expenses to reduce gross income from the source where over half of the taxpayer's total deductible R&D expenses are incurred. A taxpayer has the opportunity to apportion more than 30 percent of its R&D deduction exclusively to the source where R&D is performed if it can establish that a significantly higher percentage is warranted because the R&D is reasonably expected to have a very limited or long-delayed application outside that geographic source.

After a taxpayer makes a place-of-performance apportionment, it must apportion the amount of its R&D deduction remaining, if any, on the basis of relative amounts of domestic and foreign sales receipts. Subject to certain limitations, a taxpayer may elect to apportion its R&D deduction under an optional gross income method instead of the sales method. Under a gross income method, a taxpayer generally apportions its R&D deduction (after allocation under the legal requirements test but not the place-of-performance test) on the basis of relative amounts of gross income from domestic and foreign sources. The basic limitation on the use of optional gross income methods is that the respective portions of a taxpayer's R&D deduction apportioned to U.S. and foreign source income using a gross income method may not be less than 50 percent of the respective portions that would be apportioned to each such income grouping using the sales apportionment method (with the latter's exclusive place-of-performance allocation, typically 30 percent).

Treasury Regulation secs. 1.861-8T(e)(3) and 1.861-14T(e)(2)

In 1988, Treasury issued temporary regulations regarding the allocation and apportionment of various expenses other than interest. These regulations are generally applicable to taxable years beginning after December 31, 1986 (Treas. Reg. secs. 1.861-8T(h) and 1.861-14T(a)). Section 1.861-8T(e)(3) of the temporary regulation is expected to cover R&D expenses (Treas. Reg. sec. 1.861-14T(e)(2)). To date, however, substantive R&D allocation rules under 1.861-8T(e)(3) have not been issued or proposed. When those rules are

[6] By its terms, this R&D allocation regulation would also apply, for example, in determining the U.S. source taxable income of a foreign person, and the taxable income effectively connected with a U.S. trade or business conducted by a foreign person, insofar as those determinations are necessary under other "operative" Code sections. The operative section for the foreign tax credit limitation is section 904(a).

issued, they generally are to be applied (except with respect to R&D expenses allocated under the statutory rules, described below, of DEFRA) as if all members of the affiliated group are a single taxpayer (Treas. Reg. sec. 1.861-14T(e)(2)).

Legislative Background

Starting in 1981, Congress enacted a series of statutory R&D allocation rules to substitute, in part, for the R&D allocation regulation. The first statutory R&D allocation rule was contained in the Economic Recovery Tax Act of 1981 (ERTA), covering any taxpayer's first 2 taxable years beginning within 2 years after August 13, 1981. In the taxable years governed by this aspect of ERTA, all U.S.-incurred R&D expenses were allocated to U.S. source income. This provision was extended by the Deficit Reduction Act of 1984 (DEFRA) and the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) through taxable years beginning on or before August 1, 1986.

For taxable years beginning after August 1, 1986, and on or before August 1, 1987, the Tax Reform Act of 1986 (TRA) provided that 50 percent of research expenses (other than amounts incurred to meet certain legal requirements, and thus allocable to one geographical source) were allocated to U.S. source income, with the remainder allocated and apportioned either on the basis of sales or gross income. In contrast with the R&D allocation regulation, the temporary rule of TRA (1) gave taxpayers using the gross sales method of apportionment an automatic place-of-performance allocation, for U.S.-incurred R&D, of 50 (rather than 30) percent; (2) allowed taxpayers using the gross income apportionment method to use the automatic place-of-performance rule; and (3) imposed no limit on the extent to which use of the gross income method could result in decreasing the amount of R&D expenses that would otherwise be allocated to foreign source income using the gross sales method.

The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) effectively extended statutory allocation rules for an additional four months. The rules in effect for these four months, however, were different than those contained in previous statutes. Expenses incurred during the taxable year governed by TAMRA (for any taxpayer, its first taxable year beginning after August 1, 1987) were deemed to be incurred ratably throughout the year. For expenses deemed to have been incurred in the first four months of the year (other than amounts incurred to meet certain legal requirements, and thus allocable to one geographical source), 64 percent of U.S.-incurred R&D expenses were allocated to U.S. source income, 64 percent of foreign-incurred R&D expenses were allocated to foreign source income, and the remainder of R&D expenses were allocated and apportioned either on the basis of sales or gross income, but subject to the condition that if income-based apportionment was used, the amount apportioned to foreign source income could be no less than 30 percent of the amount that would have been apportioned to foreign source income had the sales method been used. For expenses deemed to have been incurred during the remaining eight (or fewer) months of the year governed by TAMRA, the R&D allocation regulation applied.

Pursuant to the Omnibus Reconciliation Act of 1989 (OBRA), R&D expenses incurred during a taxpayer's first taxable year beginning after August 1, 1989 and before August 2, 1990 are treated in one of the same two alternative ways as they were under TAMRA, depending on whether the expenses were in effect deemed to have been incurred in the first nine months of the year, or incurred instead during the remaining three or fewer months of the year. For these purposes total expenses for the year are deemed to be incurred evenly throughout the year. For expenses deemed paid or incurred during the first nine months of the year (other than amounts incurred to meet certain legal requirements, and thus allocable to one geographical source), 64 percent of U.S.-incurred R&D expenses are allocated to U.S. source income, 64 percent of foreign-incurred R&D expenses are allocated to foreign source income, and the remainder of R&D expenses are allocated and apportioned either on the basis of sales or gross income, but subject to the condition that if income-based apportionment is used, the amount apportioned to foreign source income can be no less than 30 percent of the amount that would be apportioned to foreign source income were the sales method used. For expenses deemed paid or incurred during the remaining months of the year, the R&D allocation regulation applies.

There are no statutory R&D allocation and apportionment rules applicable to years after the year governed by OBRA. Thus, the R&D allocation regulations generally govern allocation and apportionment of U.S.-incurred R&D expenses (as well as foreign-incurred R&D expenses) in all taxable years beginning after August 1, 1990.

Administration Budget Proposal

Under the President's fiscal year 1991 budget proposal, R&D expenses (other than amounts incurred to meet certain legal requirements, and thus allocable to one geographical source) would be sourced as follows: 64 percent of U.S.-incurred R&D expenses would be allocated to U.S. source income; 64 percent of foreign-incurred R&D expenses would be allocated to foreign source income; and the remainder of R&D expenses would be allocated and apportioned either on the basis of sales or gross income, but subject to the condition that if income-based apportionment is used, the amount apportioned to foreign source income can be no less than 30 percent of the amount that would be apportioned to foreign source income were the sales method used. The proposal would apply to all R&D expenses paid or incurred in taxable years beginning after August 1, 1990.

The substantive R&D allocation rules of the President's budget proposal are similar to those applicable in the first four months of the taxable year governed by TAMRA and the first nine months of the taxable year governed by OBRA.

7. Tax credit for qualified research expenditures (sec. 41 of the Code)

Present Law

General rule

A 20-percent tax credit is allowed to the extent that a taxpayer's qualified research expenditures for the current year exceed its base amount for that year. The credit will not apply to amounts paid or incurred after December 31, 1990, and a special rule to prorate qualified research expenditures applies in the case of any taxable year which begins before October 1, 1990, and ends after September 30, 1990.[7] Under this special proration rule, the amount of qualified research expenses incurred by a taxpayer prior to January 1, 1991, is multiplied by the ratio that the number of days in that taxable year before October 1, 1990, bears to the total number of days in such taxable year before January 1, 1991.[8]

Eligible expenditures

Research expenditures eligible for the 20-percent incremental credit under present law consist of: (1) in-house expenses of the taxpayer for research wages and supplies used in research; (2) certain time-sharing costs for computer use in research; and (3) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf. Expenditures attributable to research which is conducted outside the United States do not enter into the credit computation. In addition, the credit is not available for research in the social sciences, arts, humanities, nor is it available for research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

A 20-percent tax credit also applies to the *excess* of (1) 100 percent of corporate cash expenditures (including grants or contributions) paid for university basic research [9] *over* (2) the sum of (a) the greater of two fixed research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation.[10]

Research definition

The Tax Reform Act of 1986 provided statutory rules defining qualified research for purposes of the incremental credit. These rules target the credit to research undertaken to discover information that is technological in nature and that pertains to functional aspects of products. Also, the 1986 Act expressly excluded certain

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[7] Qualified research expenses incurred in taxable years ending on or before September 30, 1990, are eligible for the full credit. Research expenses incurred after December 31, 1990, are not eligible for the research credit.

[8] The taxpayer's base amount as otherwise determined also is prorated by multiplying such amount by the ratio that the number of days in the taxable year before October 1, 1990, bears to the total number of days in such taxable year.

[9] Expenditures paid or incurred for university basic research after December 31, 1990 are not eligible for the credit.

[10] The amount of credit-eligible basic research expenditures to which the university basic research credit applies does not enter into the computation of the incremental credit. The remaining amount of credit-eligible basic research expenditures—i.e., the amount to which the university basic research credit does not apply—enters into the incremental credit computation.

types of expenditures from eligibility for the credit, including post-production research activities, duplication or adaptation costs, and surveys, studies, and certain other costs.

Computation of allowable credit

General rule.—Except for certain university basic research payments, the credit applies only to the extent that the taxpayer's qualified research expenditures for the taxable year exceed its base amount. The base amount for the current year is computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the four preceding years.

Existing firms.—If a taxpayer both incurred qualified research expenses and had gross receipts during each of at least three years from 1984 to 1988, then its "fixed-base percentage" is the ratio that its total qualified research expenses for the 1984-1988 period bears to its total gross receipts for this period (subject to a maximum ratio of .16).

Start-up companies.—If a taxpayer did not both incur qualified research expenses and have gross receipts during each of at least three years between 1984-1988, then it is assigned a fixed-base percentage of .03.

Base limitation.—In computing the credit, a taxpayer's base amount may not be less than 50 percent of its current-year qualified research expenditures.

Aggregation rules.—To prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related entities, research expenditures and gross receipts of the taxpayer are aggregated with research expenditures and gross receipts of certain related persons for purposes of computing any allowable credit. A foreign affiliate's gross receipts which are not effectively connected with the conduct of a trade or business in the United States do not enter into the computation of the credit.

Changes in business ownership.—Special rules apply for computing the credit when a business changes hands, under which qualified research expenditures and gross receipts for periods prior to the change of ownership are treated as transferred with the trade or business which gave rise to those expenditures and receipts for purposes of recomputing a taxpayer's fixed-base percentage.

Trade or business limitations

For taxable years beginning prior to December 31, 1989, research expenditures of a taxpayer are eligible for the credit only if paid or incurred in a particular trade or business already being carried on by the taxpayer. For taxable years beginning after December 31, 1989, a taxpayer is treated as meeting the trade or business requirement with respect to in-house research expenditures if, at the time such in-house research expenditures are incurred, the principal purpose of the taxpayer in making such expenditures is to use the results of the research in the active conduct of a future trade or business of the taxpayer or certain related taxpayers.

Relation to deduction

Deductions for qualified research expenditures allowed to a taxpayer under sec. 174 or any other provision are reduced by an amount equal to 100 percent of the taxpayer's research credit determined for that year.

Legislative Background

The research credit initially was enacted in the Economic Recovery Tax Act of 1981 as a credit equal to 25 percent of the excess of qualified research expenses in the current year over the average of qualified research expenses in the prior three taxable years. The research credit was modified in the Tax Reform Act of 1986 which (1) extended the credit through December 31, 1988, (2) reduced the credit rate to 20 percent, (3) tightened the definition of research expenditures eligible for the credit, and (4) modified the university basic research credit.

The Technical and Miscellaneous Revenue Act of 1988 extended the credit for one additional year, through December 31, 1989. The 1988 Act also reduced the deduction allowed under section 174 for qualified research expenses by an amount equal to 50 percent of the research credit determined for the year.

The Omnibus Budget Reconciliation Act of 1989 effectively extended the research credit for nine months (by prorating qualified expenses incurred before January 1, 1991). The 1989 Act also (1) modified the method for calculating a taxpayer's base amount, (2) extended the availability of the credit to start-up firms which, although not presently conducting a particular trade or business, plan to use the results of their research in the active conduct of a future trade or business, and (3) further reduced the deduction allowed under section 174 for qualified research expenses by an amount equal to 100 percent of the research credit determined for the year.

Administration Budget Proposal

The President's fiscal year 1991 budget proposal would make permanent the 20-percent research tax credit by allowing 100 percent of total research expenses to be used for the computation of the credit for all years after December 31, 1989.

8. Tax credit for low-income rental housing (sec. 42 of the Code)

Present Law

A tax credit is allowed in annual installments over 10 years for qualifying low-income rental housing, which may be newly constructed, substantially rehabilitated, or newly acquired existing residential rental property. For most newly constructed and rehabilitated housing placed in service after 1987, the credit percentages are adjusted monthly to maintain a present value of the credit stream of 70 percent of the total qualified expenditures. In the case of acquisition of existing housing and of newly constructed or rehabilitated housing receiving other Federal subsidies (including tax-exempt bonds), monthly adjustments are made to maintain a 30-percent present value for the credit.

A residential rental project qualifies for the low-income housing credit only if (1) 20 percent or more of the aggregate residential rental units are occupied by individuals with incomes of 50 percent or less of area median income, as adjusted for family size, or (2) 40 percent or more of the aggregate residential rental units in the project are occupied by individuals with incomes of 60 percent or less of area median income, as adjusted for family size. Credit eligibility also depends on the existence of a 30-year extended low-income use agreement for the property. If property on which a low-income housing credit is claimed ceases to qualify as low-income rental housing or is disposed of before the end of a 15-year credit compliance period, a portion of the credit may be recaptured. The 30-year extended use agreement creates a State law right to enforce low-income use for an additional 15 years after the initial 15-year recapture period.

In order for a building to be a qualified low-income building, the building owner generally must receive a credit allocation from the appropriate credit authority. An exception is provided for property which is substantially financed with the proceeds of tax-exempt bonds subject to the State's private-activity bond volume limitation. The low income credit is allocated by State or local government authorities subject to an annual limitation for each State. The annual credit allocation was $1.25 per resident for years before 1990 and is $0.9375 per resident for 1990.

The low-income housing credit is scheduled to expire on December 31, 1990.

Legislative Background

The low-income housing credit was enacted by the Tax Reform Act of 1986, with an expiration date of December 31, 1988. The Technical and Miscellaneous Revenue Act of 1988 included a provision to extend the credit for one year. The credit was substantially revised and extended through December 31, 1990, by the Omnibus Budget Reconciliation Act of 1989 (OBRA).

To affect the equivalent of a partial-year extension of the credit OBRA reduced the annual low-income rental housing credit ceiling. In years prior to 1990, the credit ceiling for each State was $1.25 multiplied by the State's population. For calendar year 1990, that amount is reduced by 25 percent from $1.25 to $0.9375. This will result in a level of benefits and revenue loss to the Treasury equal to three-quarters of that for a full year extension.

9. Targeted jobs tax credit (sec. 51 of the Code)

Present Law

Tax credit provisions

The targeted jobs tax credit is available on an elective basis for hiring individuals from nine targeted groups. The targeted groups are: (1) vocational rehabilitation referrals; (2) economically disadvantaged youths aged 18 through 22; (3) economically disadvantaged Vietnam-era veterans; (4) Supplemental Security Income

(SSI) recipients; (5) general assistance recipients; (6) economically disadvantaged cooperative education students aged 16 through 19; (7) economically disadvantaged former convicts; (8) Aid to Families with Dependent Children (AFDC) recipients and Work Incentive (WIN) registrants; and (9) economically disadvantaged summer youth employees aged 16 or 17. Certification of targeted group membership is required as a condition of claiming the credit. In a certification request, an employer is required to (1) identify specifically the categories (up to 2) for which the employee is believed to be eligible, and (2) indicate that a good faith effort was made to determine that the employee is in a targeted group.

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

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

The credit is available with respect to targeted-group individuals who begin work for the employer before October 1, 1990.

Authorization of appropriations

Present law also authorizes appropriations for administrative and publicity expenses relating to the credit through September 30, 1990. These monies are to be used by the Internal Revenue Service (IRS) and Department of Labor to inform employers of the credit program.

Legislative Background

Extension of credit, authorization of appropriations

The targeted jobs tax credit was enacted in the Revenue Act of 1978 to replace an expiring credit for increased employment. As originally enacted, the targeted jobs credit was scheduled to terminate after 1981.

The availability of the credit was successively extended by the Economic Recovery Tax Act of 1981 (ERTA) for one year (through 1982), the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) for two years (through 1984), and the Deficit Reduction Act of 1984 (DEFRA) for one year (through 1985).

The Tax Reform Act of 1986 (the 1986 Act) extended the targeted jobs credit for three additional years (through 1988), with modifications, and the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) extended the credit with modifications for one additional year (through 1989). The Omnibus Budget Reconciliation Act of 1989 (the 1989 Act) extended the credit for nine months, through September 30, 1990.

TEFRA authorized appropriations for the expenses of administering the system, for certifying targeted group membership, and for providing publicity to employers regarding the targeted jobs credit. DEFRA, the 1986 Act, TAMRA, and the 1989 Act successively extended the authorization for appropriations for administrative and publicity expenses through fiscal year 1990.

Modification of credit

ERTA, TEFRA, and DEFRA modified the targeted group definitions and made several technical and administrative changes in the credit provisions.

The 1986 Act limited the credit in three respects: (1) a 25-percent credit for qualified wages paid in the second year of a targeted-group individual's employment was repealed; (2) a 50-percent credit for qualified first-year wages generally was reduced to a 40-percent credit (except that the credit allowed for wages of economically disadvantaged summer youth employees was retained at 85-percent of up to $3,000 of qualified first-year wages); and (3) a provision was adopted under which no wages paid to a targeted-group member are taken into account for credit purposes unless the individual either (a) is employed by the employer for at least 90 days (14 days in the case of economically disadvantaged summer youth employees), or (b) has completed at least 120 hours of work performed for the employer (20 hours in the case of economically disadvantaged summer youth employees). Under the 1986 Act, the modified credit is available for wages paid to targeted-group individuals who begin work for an employer after December 31, 1985, and before January 1, 1989.

The Omnibus Budget Reconciliation Act of 1987 provided that the credit is no longer available for wages paid to a targeted-group individual who performs the same or substantially similar services as an employee participating in, or affected by, a strike or lockout.

Two modifications were also made to the credit in TAMRA: (1) the category of economically disadvantaged youth was restricted to include employees age 18 to 22 rather than employees age 18 to 24, and (2) the credit percentage for disadvantaged summer youth employees was reduced from 85 percent to 40 percent.

10. Business energy tax credits for solar, geothermal, and ocean thermal property (secs. 46(a)(2) and 46(b)(2)(A) of the Code)

Present Law

Three nonrefundable business energy tax credits are allowed for investment in qualified energy property. The credits and the property to which they pertain are:

(1) Business solar—10% credit;
(2) Geothermal—10%; and
(3) Ocean thermal—15%.

These tax credits are currently scheduled to expire after September 30, 1990.

The energy tax credits may not be used to offset (1) more than 25 percent of regular tax liability above $25,000 or (2) the tentative minimum tax for the taxable year.

Legislative Background

The tax credits for solar and geothermal energy properties were enacted in the Energy Tax Act of 1978, effective after April 20, 1977, through December 31, 1982. The credit for ocean thermal energy property was enacted in the Windfall Profit Tax Act of 1980, effective through 1985. In the same Act, the solar and geothermal credits were extended through 1985. In the Tax Reform Act of 1986, these three credits were extended for three additional years (through 1988) at rates which phased down to the present-law tax credit rates. An additional extension for one year (through 1989) was provided in the Technical and Miscellaneous Revenue Act of 1988.

The business energy tax credits were extended for the nine-month period after December 31, 1989 (through September 30, 1990) in the Omnibus Budget Reconciliation Act of 1989.

11. Placed-in-service date for production credit for nonconventional fuels (sec. 29 of the Code)

Present Law

Nonconventional fuels are eligible for a production credit which is equal to $3 per barrel of BTU oil barrel equivalent. Qualified fuels must be produced from a well drilled, or a facility placed in service, before January 1, 1991. The production credit is available for qualified fuels produced through December 31, 2000.

Qualified fuels include (1) oil produced from shale and tar sands, (2) gas produced from geopressured brine, Devonian shale, coal seams, a tight formation, or biomass, and (3) liquid, gaseous, or solid synthetic fuels produced from coal (including lignite), including such fuels when used as feedstocks.[10a] Under section 29, the determination whether gas (item (2) above) qualifies for the credit must be made in accordance with section 503 of the Natural Gas Policy Act of 1978. Gas produced from a tight formation only included gas whose price was regulated by the United States and for which the maximum lawful price was at least 150 percent of the applicable price under section 103 of the Natural Gas Policy Act of 1978. The Federal Energy Regulating Commission deregulated natural gas in interstate commerce in 1987, and as a result, the production credit no longer was available to gas produced from tight formation.

Legislative Background

The production credit was originally enacted in the Windfall Profit Tax Act of 1980, with a requirement that the property generally be placed in service before January 1, 1990.

In the Technical and Miscellaneous Revenue Act of 1988, the placed-in-service date was extended from January 1, 1990, to January 1, 1991.

[10a] A production credit for processed wood fuel was available for fuel produced from a facility placed in service before January 1, 1982, and sold before the later of October 1, 1983, or 3 years after the facility was placed in service.

A credit was available for steam produced from solid agricultural by-products in facilities placed in service after December 31, 1979, and sold before January 1, 1985.

During consideration of the Omnibus Budget Reconciliation Act of 1989, the Senate Committee on Finance approved an amendment (included in S. 1750 as reported by the Senate Committee on the Budget) that would restore eligibility for the production credit to unregulated gas from tight formations that is produced from wells drilled on or after January 1, 1990, and would restore eligibility for the credit to such gas which had been eligible for the credit before gas was deregulated. This provision was deleted from the bill by Senate floor amendment.

An interagency task force within the Executive Branch, which includes at least representatives of the Departments of Treasury and Energy, is currently attempting to resolve a dispute about the appropriate definition of tar sands and to develop a satisfactory working definition.

12. Tax credit for orphan drug clinical testing expenses (sec. 28 of the Code)

Present Law

A 50-percent nonrefundable tax credit is allowed for a taxpayer's qualified clinical testing expenses paid or incurred in the testing of certain drugs, generally referred to as orphan drugs, for rare diseases or conditions. Present law defines a rare disease or condition as one that (1) affects less than 200,000 persons in the U.S. or (2) affects more than 200,000 persons, but there is no reasonable expectation that businesses could recoup the costs of developing a drug for it from U.S. sales of the drug. These rare diseases and conditions include Huntington's disease, myoclonus, ALS (Lou Gehrig's disease), Tourette's syndrome, and Duchenne's dystrophy (a form of muscular dystrophy).

Legislative Background

This provision was enacted initially in the Orphan Drug Act of 1983, and was scheduled to expire after 1987. The credit was extended for three years in the Tax Reform Act of 1986, through December 31, 1990.

B. Expiring Excise Tax Provisions

1. Airport and Airway Trust Fund excise taxes (secs. 4041(c), 4081, 4091, 4261, and 4271 of the Code)

Present Law

Excise taxes which are imposed on air transportation for transfer to the Airport and Airway Trust Fund are (1) an 8-percent tax on air passenger transportation, (2) a 5-percent tax on air freight, (3) a $6 per passenger tax on international departures, (4) a tax of 12 cents per gallon on gasoline used in noncommercial aviation, and (5) a tax of 14 cents per gallon on nongasoline (jet) fuels. These taxes are scheduled to expire after December 31, 1990.

The Airport and Airway Revenue Act of 1987 provided, however, that the taxes generally would be reduced by 50 percent (except for the departure tax) beginning on January 1, 1990, if the appropriations from the Trust Fund for fiscal years 1988 and 1989 for airport improvements, facilities and equipment, and research, engineering, and development were less than 85 percent of the total amounts authorized for these programs for fiscal years 1988 and 1989. Since the appropriations for 1988 and 1989 for the affected programs were only 79 percent of the authorized amounts, the reduction would have gone into effect on January 1, 1990. However, the Omnibus Budget Reconciliation Act of 1989 suspended the tax rate reduction for one year, and it will become effective as of January 1, 1991, assuming extension of these excise taxes, if the amounts appropriated for fiscal years 1989 and 1990 for the programs listed above are less than 85 percent of the amounts authorized for those programs.

Funding for Federal Aviation Administration (FAA) operations and maintenance from the Trust Fund is limited to 50-percent of the total amount appropriated for airport improvements, facilities and equipment, and research, engineering, and development. In addition, if the fiscal year appropriated amount is less than the amount authorized for these programs, the amount available from the Trust Fund for operations and maintenance is limited further by twice the amount of such shortfall.

Legislative Background

The Airport and Airway Trust Fund and the excise taxes earmarked for deposit in the trust fund were enacted in the Airport and Airway Revenue Act of 1970. The 50-percent reduction in excise tax rates that would be effective if appropriated amounts would be less than the threshold 85-percent requirement was enacted in the Airport and Airway Revenue Act of 1987.

The Omnibus Budget Reconciliation Act of 1989 suspended application of the trigger for one year, until January 1, 1991. The 1989 Act also increased the international departure tax from $3 to $6 per person on January 1, 1990.

Appropriations for airport improvements, facilities and equipment, and research, engineering and development for fiscal year 1990 were increased above the budget recommendation with the concurrence of the Administration.

Administration Budget Proposal

The President's budget proposal for fiscal year 1991 requested extension of the aviation-related excise taxes with increases in the levels of the air passenger and air freight taxes to 10 percent and 6.25 percent, respectively, and increases in the noncommercial aviation gasoline tax to 15 cents per gallon and the noncommercial aviation jet fuel tax to 17.5 cents per gallon. The proposal would not affect the international air departure tax which was increased to $6 as of January 1, 1990. In addition, the tax reduction trigger would be repealed.

2. Excise tax on communications (telephone) services (sec. 4251 of the Code)

Present Law

Imposition of tax

A 3-percent excise tax is imposed on amounts paid for local and toll (long-distance) telephone service and teletypewriter exchange service. The tax is collected by the provider of the service from the consumer (business and person service). The tax is scheduled to expire after December 31, 1990.

Exemptions from the telephone excise tax are allowed for installation charges, certain coin-operated service, news services (except local service), international organizations, the American Red Cross, servicemen in combat zones, nonprofit hospitals and educational organizations, State and local governments, and for toll telephone service paid by a common carrier, telephone or telegraph company or radio broadcasting company in the conduct of its business. In addition, an exemption is provided for private communications systems (e.g., certain dedicated lines leased to a single business user).

Collection of tax

Under present law, the telephone tax billed to the customer in a semi-monthly period is considered to be collected from the customer during the second following semi-monthly period. Such tax must be deposited in a Federal Reserve Bank or other authorized depository within 3 banking days after the end of the semi-monthly period for which the tax is considered collected. (Rev. Proc. 76-45, 1976-2 C.B. 668).

Legislative Background

An excise tax on telephone service has been in effect in every year since 1941.[11] In the Excise Tax Reduction Act of 1965, the 10-percent tax on local and long distance telephone service and teletypewriter exchange service was scheduled to be reduced from 10 percent to 3 percent after December 31, 1965, and by an additional

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[11] A tax on toll telephone service originated in 1898, with a tax of one cent for each call valued at fifteen cents or more. This tax was repealed in 1902. A tax on toll service was reenacted in 1914, with the tax on a per-message basis. This tax was repealed and reimposed several times until being changed to a 10-percent tax in 1941. The toll telephone tax rate was 20 percent for 1942-1943 and 25 percent from 1944-1954. The tax on other telephone service originated in 1941 at 10 percent, and was 15 percent from 1944-1954.

1 percentage point in each successive year until there would have been no tax effective on January 1, 1969. However, the scheduled reduction in tax rates was rescinded in the Tax Adjustment Act of 1966, and a revised phaseout was scheduled to go into effect on January 1, 1970. This also was deferred, and a one-percent-per year phaseout went into effect on January 1, 1973.

In 1973, the rate of tax declined from 10 percent to 9 percent as the first step in a schedule according to which the rate of tax was to decline by one percentage point per year and thus to expire as of January 1, 1982. However, the Omnibus Budget Reconciliation Act of 1980 delayed the repeal by one year until January 1, 1983; and the Economic Recovery Tax Act of 1981 further delayed repeal for two additional years, or until January 1, 1985. The Tax Equity and Fiscal Responsibility Act of 1982 increased the rate of tax to 3 percent and extended the termination date to January 1, 1986. The Deficit Reduction Act of 1984 delayed repeal for an additional two years, or until January 1, 1988. The Omnibus Budget Reconciliation Act of 1987 further delayed repeal until January 1, 1991.

The Omnibus Budget Reconciliation Act of 1989 as passed by the House of Representatives (H.R. 3299) included a permanent extension of the 3-percent telephone excise tax. The provision was dropped in conference. In addition, in 1989 the Senate passed, as part of S. 5, a permanent extension of the 3-percent telephone excise tax. Also, both H.R. 3299, as passed by the House, and S. 5, as passed by the Senate, would have modified the collection period for the tax.

Administration Budget Proposal

Extension of tax

The President's fiscal year 1991 budget proposal would make the Federal telephone excise tax permanent at its current 3-percent rate.

Collection of tax

The President's budget proposal also would modify the collection period so that the tax for a semi-monthly period would be considered as collected during the first week of the second semi-monthly period. Deposit of tax would be required to be made within 3 banking days after the end of the week for which the tax is considered to be collected. The change would be effective for taxes considered collected for semi-monthly periods beginning after December 31, 1990.

3. Excise tax on deep seabed minerals (and Deep Seabed Revenue Sharing Trust Fund) (secs. 4495-4498 of the Code)

Present Law

Overview

The Deep Seabed Hard Mineral Resources Act (the Resources Act, P.L. 96-283), one title of which is the Deep Seabed Hard Mineral Removal Tax Act of 1979 (the Tax Act), was enacted into law on June 28, 1980. The Resources Act was intended to perform several functions. First, it established an interim program that was intended to encourage and regulate the development of hard mineral resources of the deep seabed by U.S. persons, pending the entry into force with respect to the United States of a superseding international agreement relating to such activities. Second, it was intended to ensure that the hard mineral resources of the deep seabed would be developed in a manner that would be orderly and efficient, that would protect the environment, and that would promote the safety of life and property at sea.

Third, the Resources Act was intended to encourage the successful negotiation of an international deep seabed treaty by the United Nations Conference on the Law of the Sea (a U.N. international deep seabed treaty), and pending the entry into force of such a treaty, to establish a special fund to support international revenue sharing from deep seabed mineral recovery. To this end the Act established an interim trust fund in the Treasury, the Deep Seabed Revenue Sharing Trust Fund (the Trust Fund), into which any Tax Act receipts would be deposited. The Trust Fund proceeds would be used to help discharge any U.S. financial obligations under a U.N. international deep seabed treaty should the United States become a party thereto.

Subsequent to the enactment of the Resources Act, the U.N. Conference on the Law of the Sea completed negotiations for an international deep seabed treaty, and the United States announced that it would not sign the treaty.

Excise tax on certain hard minerals

The Tax Act added sections 4495 through 4498 to the Internal Revenue Code. These sections would impose an excise tax on the removal from the deep seabed of certain hard mineral resources pursuant to a deep seabed permit issued under the Resources Act. In general, a deep seabed permit issued under the Resources Act would authorize its holder to engage in commercial recovery activities with respect to hard mineral resources on or under deep seabeds. No such permits have been issued.

Deep seabeds are, in general, areas outside the continental shelf of any nation. In general, hard mineral resources are mineral nodules, lying on or just below the surface of deep seabeds, that contain one or more minerals including manganese, nickel, cobalt, or copper. Under the Tax Act, if a person removes a hard mineral resource from the deep seabed pursuant to a deep seabed permit, a tax is imposed on the permit holder equal to 3.75 percent of 20 percent (or 0.75 percent) of the fair market value of the commercially recoverable minerals removed. In general, fair market value is determined as of the removal date and as if the minerals were separated from the deposit.

The Tax Act will terminate on the earlier of the date on which a U.N. international deep seabed treaty takes effect with respect to the United States, or June 28, 1990 (10 years after the date of enactment of the Tax Act).

International deep seabed treaties

On April 30, 1982, the United Nations Conference on the Law of the Sea adopted an international deep seabed treaty called the Law of the Sea Convention (the Convention) by a vote of 130 in favor to 4 against, with 17 abstentions. If and when the Convention enters into force, it would establish a regime for the regulation of mineral extraction from the deep seabed, and would impose revenue obligations on its adherents. Such obligations would be fundable by the Deep Seabed Revenue Sharing Trust Fund if the United States were to become obligated by the Convention.

The Convention does not enter into force unless ratified or acceded to by 60 countries. The Convention has been ratified by 42 countries as of December 31, 1989. The 159 countries that signed the Convention comprise most of the world's developed and developing countries, including Australia, Belgium, Canada, China, Czechoslovakia, France, Hungary, Italy, Japan, the Netherlands, Poland, and the Soviet Union, and by the European Community (formerly the European Economic Community). However, on July 9, 1982, President Reagan announced that his Administration would not sign the Convention on behalf of the United States, and the Convention has not been submitted to the Senate for its advice and consent. Along with the United States, the Federal Republic of Germany, Israel, Turkey, the United Kingdom and Venezuela did not sign the Convention and have not acceded to it as of December 31, 1989.

The United States has entered into certain international executive agreements (one multilateral agreement in 1984 and a series of bilateral agreements in 1987) pertaining to certain subjects otherwise addressed in the Law of the Sea Convention. Such agreements, which are not treaties and have no connection to the U.N. Conference on the Law of the Sea, impose no revenue obligations on the United States related to the deep seabed.

The technology necessary for commercial recovery of minerals from the deep seabed has not yet been developed.

Legislative Background

The deep seabed tax and trust fund provisions of the Tax Act have not been substantively amended since enactment. The Resources Act has been reauthorized through fiscal year 1994 without substantive amendment.

Section 403 of the Deep Seabed Resources Act established the Deep Seabed Revenue Sharing Trust Fund in the Treasury, as noted above. This fund was intended to be the depository for an amount of money equal to the total collections under the Tax Act. As noted above, there have been no collections under the Tax Act, and there will be no collections unless deep seabed permits are issued and certain minerals are extracted under those permits. Any amounts deposited in the fund would be invested in interest-bearing obligations of the United States. Any expenditures from the fund during its existence would be for the purpose of discharging the obligations of the United States under a U.N. international deep seabed treaty to which the United States might become a party. If, by the time the Tax Act terminates (June 28, 1990), the United States has not become a party to such a treaty but revenues *have* been collected under the Tax Act, the fund would be available for such purposes as Congress may provide.

C. Other Expiring Provisions

1. Limitations on grant administrative expenses qualifying for payout requirements of private foundations (sec. 4942(g)(4) of the Code)

Present Law

In general

Code section 4942 in effect requires private nonoperating (grant-making) foundations [12] to make qualifying distributions, by the end of the following year, at least equal to five percent of the fair market value of its net investment assets for the year, reduced by certain carryovers and taxes paid by the foundation. Qualifying distributions include direct expenditures to accomplish charitable purposes and grants to public charities or private operating foundations.[13] In general, reasonable and necessary administrative expenses incurred for such charitable purposes count, without limitation, as qualifying distributions (sec. 4942(g)(1); Treas. Reg. sec. 53.4942(a)-3(a)(2)(i)).

Special limitation on grant administrative expenses

General rules

Under special rules enacted in the Deficit Reduction Act of 1984, the amount of grant administrative expenses paid during a taxable year which may be taken into account as qualifying distributions may not exceed the excess, if any, of (1) 0.65 percent of the aggregate amount of the net assets of the foundation for the year and for the immediately preceding two taxable years, over (2) the aggregate amount of grant administrative expenses paid during the two preceding taxable years which were taken into account as qualifying distributions (sec. 4942(g)(4)).

Definitions

The term "grant administrative expenses" means any administrative expenses (e.g., compensation to officers and employees, employee expense reimbursements, and legal or accounting fees) that are allocable to the making by the foundation of any contribution, gift, or grant (whether to organizations or individuals) that is a qualifying distribution.[14] If a payment by a foundation is a contribution, gift, or grant that is a qualifying distribution, then all administrative expenses (whether direct or indirect expenses) allocable to the payment are grant administrative expenses.[15]

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[12] The minimum distribution rules under section 4942 do not apply to private operating foundations. However, to qualify for operating status, a private foundation must meet certain payout requirements.

[13] If certain requirements are met, a foundation also may count amounts "set aside" to be paid within five years for a specific project as qualifying distributions in the year set aside (rather than in the year such amounts are actually expended).

[14] For purposes of this provision, a set-aside (sec. 4942(g)(2)) which is made for purposes of making a contribution, gift, or grant constitutes a contribution, gift, or grant in the taxable year in which treated as a qualifying distribution, and all administrative expenses allocable to such a set-aside are grant administrative expenses.

[15] An expense, such as wages paid to the foundation's president or to payroll or bookkeeping employees, that may be allocable both to the making of a qualifying distribution grant and also to other activities (e.g., direct operating activities or investment activities) must be allocated among such activities of the foundation pursuant to a reasonable and consistent method.

Termination date of special limitation on grant administration expenses

The limitation on the extent to which grant administrative expenses may be counted as qualifying distributions does not apply to taxable years beginning after December 31, 1990 (sec. 4942(g)(4)(F)).

Legislative Background and IRS Study of Foundation Grant Administrative Expenses

The special rules relating to grant administrative expenses of private foundations were enacted in the Deficit Reduction Act of 1984 (the "1984 Act").

The 1984 Act also required the Treasury Department to submit a study to the tax-writing committees concerning grant administrative expenses incurred by nonoperating and operating foundations. On February 2, 1990, the Commissioner of Internal Revenue forwarded the results of the study to the Congress, and indicated that the IRS (and the Treasury Department) concluded that the limitation (section 4942(g)(4)) should be allowed to terminate on December 31, 1990, as scheduled.[16]

The major findings of the IRS study were as follows: [17]

o "The limit on grant-making administrative expenses in section 4942(g)(4) of the Code was not an effective method of discouraging foundations from incurring excessive amounts of these administrative expenses. Small foundations were the most likely to incur excessive amounts, but these foundations also tended to make excess qualifying distributions, thus posing little, if any, potential for tax liability under section 4942. In no instance was a tax incurred as a result of a foundation exceeding the grant-making administrative expenses limit."

o "The grant-making administrative expenses limit, formulated as a percentage of net noncharitable assets, had no discernible impact on abusive situations, such as the payment of excessive compensation. Abusive situation were controlled by the existing excise tax provision under Chapter 42; the grant-making administrative expenses limit did not provide any additional deterrent."

o "Computations regarding the grant-making administrative expenses limit were complex and burdensome to private foundations. Consequently, the error rate of private foundations' reporting in this area was high. The private foundations' miscalculations, in turn, caused administrative difficulties for the IRS."

o "Private foundations were in substantial compliance with the provision of the tax laws that apply to them."

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[16] Letter of February 2, 1990, from Fred T. Goldberg, Jr., Commissioner of Internal Revenue, to Ronald A. Pearlman, Chief of Staff, Joint Committee on Taxation.

[17] *Ibid.* See Internal Revenue Service, *Private Foundations: Grant-making Administrative Expense Study*, January 1990.

2. IRS user fees (sec. 10511 of the Omnibus Budget Reconciliation Act of 1987)

Present Law

The Internal Revenue Service (IRS) provides written responses to questions of individuals, corporations, and organizations relating to their tax status or the effects of particular transactions for tax purposes. The IRS responds to these inquiries through the issuance of letter rulings, determination letters, and opinion letters. The IRS charges a fee for most requests for a letter ruling, determination letter, opinion letter, or other similar ruling or determination. The fee charged may vary depending on the type of request, although the legislation specifies minimum average fees for each type of request. The legislation that requires the establishment of this fee program provides that it is not to apply to requests made after September 30, 1990.

Legislative Background

The Omnibus Budget Reconciliation Act of 1987 required the IRS to establish a program that requires the payment of a fee for most requests for a letter ruling, determination letter, opinion letter, or other similar ruling or determination (with the sunset date of September 30, 1990).

Administration Budget Proposal

Under the President's fiscal year 1991 budget proposal, the IRS program that requires the payment of a fee for most requests for a letter ruling, determination letter, opinion letter, or other similar ruling or determination would be permanently extended.

3. Federal unemployment tax (FUTA) 0.2-percent surtax (sec. 3301 of the Code)

Present law

The Federal Unemployment Tax Act (FUTA) imposes a gross employer tax of 6.2 percent on the first $7,000 paid annually to each employee. Employers in States meeting certain requirements and with no overdue Federal loans are eligible for a full 5.4 percentage point credit, making the basic net FUTA tax rate 0.8 percent. This 0.8-percent tax rate has a permanent component of 0.6 percent and a temporary component of 0.2 percent. The 0.2-percent surtax is scheduled to expire for wages paid after 1990.

Legislative Background

The 0.2-percent surtax was originally enacted in the Unemployment Compensation Amendments of 1976. The surtax was scheduled to expire at the end of the year in which the Unemployment Trust Fund paid off an $8.7 billion debt incurred in the 1970s. Since this debt was repaid in May 1987, the 0.2-percent surtax was scheduled to expire at the end of 1987.

In the Omnibus Budget Reconciliation Act of 1987, the 0.2-percent surtax was extended for three years, through 1990.

APPENDIX:

ESTIMATED REVENUE EFFECTS OF EXTENDING EXPIRING PROVISIONS PERMANENTLY

Table 1. Expiring Income Tax Provisions

(Provisions with Negative Revenue Effects)

Fiscal Years 1991–1995

[Millions of Dollars]

Provision	Expiration date	1991	1992	1993	1994	1995	1996
Expiring Income Tax Provisions							
1. Employer-provided educational assistance	9/30/90	−225	−331	−345	−358	−372	−1,661
2. Employer-provided group legal services	9/30/90	−80	−108	−113	−120	−125	−546
3. Deduction for health insurance for self-employed individuals	[1] 12/31/90	−374	−473	−544	−626	−720	−2,737
4. Mortgage revenue bonds and mortgage credit certificates	9/30/90	−10	−50	−140	−240	−330	−770
5. Qualified small-issue manufacturing bonds	9/30/90	−10	−50	−120	−190	−260	−630
6. Foreign allocation and apportionment of research expenditures	[2] 8/1/90	−503	−708	−772	−837	−903	−3,723
7. Research and experimentation credit [3]	[1] 12/31/90	−922	−1,175	−1,299	−1,443	−1,575	−6,414
8. Low-income housing tax credit	[1] 12/31/90	−173	−454	−827	−1,299	−1,613	−4,296

9. Targeted jobs tax credit	9/30/90	−81	−154	−211	−242	−266	−954
10. Business energy credits (solar, geothermal, and ocean thermal property)	9/30/90	−55	−54	−41	−42	−45	−237
11. "Placed-in-service date" for nonconventional fuels production credit	12/31/90	−6	−14	−20	−26	−33	−99
12. Orphan drug tax credit	12/31/90	−4	−7	−7	−7	−7	−32
Totals, Expiring Income Tax Provisions		**−2,473**	**−3,578**	**−4,439**	**−5,360**	**−6,249**	−22,099

[1] The Omnibus Budget Reconcilliation Act of 1989 extended these provisions for a 9-month prorated portion of the year.

[2] The Omnibus Budget Reconcilliation Act of 1989 extended this provision on a prorated basis for 9 months after start of a firm's first tax year beginning after August 1, 1989.

[3] Estimate reflects a phased-in increase in the base limitation to 75% taxable years beginning in 1995 or later (as provided for in the permanent extension of the credit approved by both the House of Representatives (in H.R. 3299) and the Senate Finance Committee (included in S. 1750 as reported by the Senate Budget Committee).

Notes: All estimates assume full restoration of tax benefits for 1990, and permanent extension thereafter. Estimates assume legislation enactment date of October 1, 1990

Table 2. Expiring Excise Tax Provisions and Other Expiring Provisions

(Provisions With Positive or No Revenue Effects)

Fiscal Years 1991–1995

[Millions of Dollars]

Provision	Expiration date	1991	1992	1993	1994	1995	1991–95
Excise Tax Provisions							
1. Airport and Airway Trust Fund excise taxes—air passenger, air cargo, international departure, and general aviation fuels taxes [1,2]	12/31/90						
2. Telephone excise tax [1]	12/31/90	1,520	2,570	2,748	2,936	3,135	12,909
3. Excise tax on deep seabed hard minerals [3]	6/28/90						
Subtotals, Expiring Excise Tax Provisions		**1,520**	**2,570**	**2,748**	**2,936**	**3,135**	**12,909**

Other Expiring Provisions							
1. Limitations on grant administrative expenses of private foundations	12/31/90	(4)	(4)	(4)	(4)	(4)	(4)
2. IRS user fees	9/30/90	60	60	60	60	60	300
3. FUTA 0.2% surtax [1]	12/31/90	774	1,087	1,117	1,146	1,178	5,302
Subtotals, Other Expiring Provisions		**834**	**1,147**	**1,177**	**1,206**	**238**	**5,602**
Totals		**2,354**	**3,717**	**3,925**	**4,142**	**4,373**	**18,511**

[1] Estimate for this provision was supplied by the Congressional Budget Office (CBO).

[2] Airport and Airway Trust Fund (AATF) taxes are scheduled to expire after 12/31/90 under present law; in addition, some components of these taxes are subject to reduction if spending from the AATF does not reach certain designated levels (the "trigger"). In conformity with the definition of the reserve base contained in the Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987, the CBO baseline assumes extension of the current AATF taxes with the trigger in effect. Therefore, as shown in the table, extension of AATF taxes with the trigger on has no budget effect. However, failure to extend these taxes at their current levels would reduce estimated baseline receipts by the following amounts (millions of dollars): $1,042 for FY 1991; $1,829 for FY 1992; $1,953 for FY 1993; $2,117 for FY 1994; and $2,309 for FY 1995. Alternatively, extension of the current AAFT taxes with the trigger removed would increase estimated budget receipts by the following amounts (millions of dollars): $887 for FY 1991; $1,558 for FY 1992; $1,668 for FY 1993; $1,813 for FY 1994; and $1,985 for FY 1995.

[3] No receipts are anticipated from the extension of this provision because no producers are expected to be licensed and ready for production within this 5-year period.

[4] Negligible gain.

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