DESCRIPTION OF PROPOSAL BY CHAIRMAN ROSTENKOWSKI RELATING TO CHILD CARE AND THE EARNED INCOME TAX CREDIT, EXPIRING TAX PROVISIONS, MEDICARE CATASTROPHIC INSURANCE PROVISIONS, AND CERTAIN OTHER REVENUE PROVISIONS

For Consideration

by the

COMMITTEE ON WAYS AND MEANS

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

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CONTENTS

INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation,[2] provides a description of a proposal by Chairman Rostenkowski relating to:

(1) Child care initiatives, including expansion of the earned income tax credit;

(2) Extension of certain expiring tax provisions;

(3) Modification of the Medicare catastrophic insurance provisions;

(4) Restoration of the 10-percent personal interest deduction for 1990;

(5) Subcommittee-related items, including simplification of the corporate alternative minimum tax, modification of the rehabilitation tax credit, and the Caribbean Basin Initiative; and

(6) Certain revenue-offset provisions.

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[1] This document may be cited as follows: Joint Committee on Taxation, Description of Proposal by Chairman Rostenkowski Relating to Child Care and the Earned Income Tax Credit, Expiring Tax Provisions, Medicare Catastrophic Insurance Provisions, and Certain Other Revenue Provisions (JCX-31-89), July 18, 1989.

[2] Descriptions of the following provisions were prepared by the staff of the Committee on Ways and Means: Title XX block grants for child care services and the Caribbean Basin Initiative.

I. CHILD CARE INITIATIVE

A. Expanded Earned Income Tax Credit

Present Law

The earned income tax credit (EITC) provides an advanced refundable tax credit to taxpayers who maintain a household for one or more children. In 1989, the credit is equal to 14 percent of the first $6,500 of earned income. The credit is phased out at a rate of 10 percent of the amount of adjusted gross income (or, if greater, the earned income) that, in 1989, exceeds $10,240. The $6,500 and $10,240 amounts are adjusted annually for inflation, so that the maximum credit amount and the maximum amount of income eligible for the credit increase with inflation.

In order to be eligible for the EITC, the taxpayer must, in general, be entitled to claim the child as a dependent, and thus must provide over half of the support for the child. For this purpose, benefits under the Aid to Families with Dependent Children (AFDC) program are not considered support provided by the taxpayer. Thus, if more than half of the taxpayer's income is from AFDC or sources other than the taxpayer's own income, the earned income tax credit generally is not available.

Explanation of Proposal

EITC expanded and adjusted for family size

The proposal would increase the amount of earned income tax credit and adjust the credit for family size. Using the present-law income breakpoints, the credit and phaseout percentages would be increased according to the number of eligible children in the taxpayer's household as follows:

Number of Children	Credit Percentage	Phaseout Percentage	Projected Maximum Credit Amount[3]
1	17%	12%	$1,217
2	21%	15%	$1,504
3 or more	25%	18%	$1,790

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[3] The maximum credit amounts are projections for calendar year 1991. The maximum present law credit is projected to be $1,002 in 1991.

Supplemental young child amount

If any of the taxpayer's eligible children are under the age of 6, the proposal would provide a further credit amount. This supplemental credit amount would be available in addition to the EITC amount determined by family size. The supplemental young child credit would be calculated as 6 percent of the first $6,500 of earned income (as adjusted for inflation). Thus, the maximum amount of supplemental young child credit is projected to be $430 in 1991. The credit would be phased out at a rate of 4.25 percent of adjusted gross income (or earned income, if greater) in excess of $10,240 (as adjusted for inflation).

Other modifications

In order to increase utilization of the advanced payment system, the proposal would require employers to receive from new employees certification of eligibility for advance payments of the earned income credit.

The proposal would treat the amount of benefits provided under Federal means-tested transfer payment programs (such as AFDC) as support provided by the taxpayer for purposes of the support test in determining eligibility for the earned income tax credit. The proposal would also provide that the amount of the earned income tax credit is not treated as income in determining eligibility for all Federal, State, and local means-tested public assistance programs.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1990.

B. EXPANSION OF THE TITLE XX SOCIAL SERVICES BLOCK GRANT FOR CHILD CARE SERVICES

Present Law

Under Title XX of the Social Security Act, States are entitled to receive social services block grant funds. These funds must be used to provide services directed at achieving five national goals: preventing or reducing dependency; achieving self-sufficiency; preventing or remedying neglect, abuse or exploitation of children and adults; preventing or reducing inappropriate institutional care; and providing services or referrals to individuals in institutions.

Title XX is a capped entitlement; funds are currently limited to $2.7 billion annually. (Note: As part of its reconciliation bill the Committee has approved an increase in the entitlement ceiling; under the Committee's plan, by 1993 the entitlement ceiling will reach $3.3 billion.) Nearly all States use a portion of their Title XX funds to provide child care assistance to needy families.

Proposal

Permanently increase funds for Title XX of the Social Security Act by $350 million for fiscal year 1991 and $400 million in fiscal year 1992 and each subsequent year. These additional funds would be earmarked and could not be used to supplant Federal and State funds currently used for this purpose. States would be required to use at least 80 percent of the monies for child care services; the remaining 20 percent would be used for child care-related administration and training as well as enforcement of child care standards.

Child care expenses would be reimbursed at market rates, with higher reimbursements for infants and toddlers, children with disabilities, and comprehensive child care programs for children of adolescent parents. States would be required to establish a sliding fee schedule for the delivery of child care services and must assure that such services are provided at no cost to families with incomes below the poverty level. The State agency with primary responsibility for child care would administer these funds.

Establishment of State Child Care Standards

A State that receives funds earmarked for child care under Title XX must, beginning three years after enactment, have in effect State child care standards that address all of the matters specified below (see Required Categories for State Standards).

The standards must apply to all Title XX funded child care and to any child care services delivered by providers that receive public funds for child care services. Each provider who receives funds earmarked for child care under Title XX must also comply with all applicable State and local licensing or regulatory requirements (including registration requirements).

A State would be ineligible for the additional Title XX funds beginning four years after enactment unless it demonstrates that all Title XX funded child care providers and all other providers that receive public funds for child care services are: (1) licensed and regulated as required by State and local law; (2) satisfy any applicable State standards; and (3) are subject to enforcement provisions that parallel those in H.R. 3.

There would exist no requirement, or mandate on the States to require, the training or licensing of individuals who provide child care to members of their families.

<u>Required Categories for State Standards</u>

1. <u>Center-based Child Care Services</u>

-- group size limits in terms of the number of caregivers and number and ages of children;
-- maximum appropriate child-staff ratios;
-- qualifications and background of child care personnel;
-- requirements for inservice training;
-- health and safety requirements, including requirements for the prevention and control of infectious diseases (including immunization and handwashing procedures), injury prevention and treatment, building and physical premises safety, general health and nutrition, children with special needs, and prevention of child abuse; and
-- requirements for parental involvement in licensed and regulated child care services.

2. <u>Family Child Care Services</u>

-- maximum number of children and maximum number of infants for whom child care services should be provided;
-- minimum age of caregivers;
-- requirements for inservice training; and
-- health and safety requirements (including those described above for center-based child care services, as are appropriate for family child care services).

3. <u>Group Home Child Care Services</u>

-- maximum appropriate child staff ratios;
-- maximum number of children and maximum number of infants

for whom child care services should be provided;
- -- minimum age of caregivers;
- -- requirements for inservice training; and
- -- health and safety requirements (including those described above for center-based child care services, as are appropriate for group home child care services).

Training Requirement

Beginning 2 years after enactment, any State that receives the earmarked Title XX funds must require that all Title XX child care providers and any other child care providers that receive public funds for child care services, and the caregivers employed by such providers, complete an average of 15 hours of training annually. Such training must be tailored to the needs of the State and the providers.

Limitation on State Standards

The State may not reduce the categories of child care providers licensed or regulated by the State, or reduce the level of standards applicable to child care services provided in the State, unless the State demonstrates, to the satisfaction of the Secretary, that the reduction is: (1) based on positive developmental practice; or (2) necessary to increase access to and availability of child care providers and will not jeopardize the health and safety of children.

Incentive Grants

Beginning with fiscal year 1990, authorize a Child Care Standards Improvement Incentive Grant Program to assist States in improving child care standards in the categories described above. Grants would be for a 2-year period with no State receiving more than 3 consecutive grants. The Federal matching rate would be 80 percent. Authorize $75 million annually for this purpose through fiscal year 1998.

II. EXTENSION OF CERTAIN EXPIRING TAX PROVISIONS

A. Temporary Extensions

1. Exclusion for Employer-Provided Educational Assistance

Present Law

Under present law, an employee is required to include in income, 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 continuing employment.

Under prior law, an employee's gross income for income and employment tax purposes also did not include amounts paid or incurred by the employer for educational assistance provided to the employee if such amounts were paid or incurred pursuant to an educational assistance program that met certain requirements including nondiscrimination rules (sec. 127). The exclusion did not apply to any payment for, or the provision of any benefits with respect to, any graduate-level courses. This exclusion, which expired for taxable years beginning after December 31, 1988, was limited to $5,250 of educational assistance with respect to an individual during a calendar year.

The Deficit Reduction Act of 1984 required that employers file information returns with respect to educational assistance plans under section 127 (sec. 6039D). The purpose of this requirement was to collect data with respect to the use of such plans so as to provide Congress with a means to evaluate the effectiveness of the exclusion.

Explanation of Proposal

The exclusion for employer-provided educational assistance would be restored retroactively to the date of the prior expiration; and the exclusion would be extended for three years so that it expires for taxable years beginning after December 31, 1991. The proposal would also clarify that, to the extent employer-provided educational assistance is not excludable under section 127 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 section 162). Educational assistance could not be excluded under any other provision of section 132.

Effective Date

The proposal would be effective on the date of enactment.

2. Targeted Jobs Tax Credit

Present law

Under present law, the targeted jobs tax credit is available on an elective basis to employers for hiring individuals from nine targeted groups. Certification of targeted group membership is required as a condition of claiming the credit.

The credit generally is equal to 40 percent of the first $6,000 of qualified first-year wages paid to a member of a targeted group, for a maximum credit of $2400. 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 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 January 1, 1990.

Present law also authorizes appropriations for administrative and publicity expenses relating to the credit through September 30, 1989. These monies are to be used by the Internal Revenue Service (IRS) and Department of Labor to inform employers of the credit program.

Explanation of Proposal

The proposal would extend the targeted jobs tax credit for two years (through December 31, 1991), and adopt the modification recommended by the Select Revenue Measures Subcommittee.

The modification would require that employers specifically identify the categories (but not to exceed two) for which the individual is believed to be eligible when requesting certification and would have to indicate that a good faith effort was made to determine that the individual may be eligible for the credit.

Effective Date

The proposal would apply to targeted-group individuals who begin work for an employer after December 31, 1989, and before January 1, 1992. Authorization for administrative and publicity expenses would be provided for fiscal years 1990 through 1991.

3. Qualified Mortgage Bonds and Mortgage Credit Certificates

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 net proceeds of which are used 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.

Eligible purchasers

In general, eligible purchasers must have not owned a residence with the three prior years and must have incomes below 115 percent of the median income for the area or State where the residence is located. For families consisting of less than three persons, the income limitation is 100 percent of the area or State median income.

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.

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.

Limitations on volume, arbitrage and unspent proceeds

Mortgage revenue bonds are subject to the general per capita volume limitation on private purpose obligations. Issuers of mortgage subsidy bonds generally must issue mortgages at rates that cannot exceed the rate of interest on the bonds by more than 1.125 percentage points. In general, bond proceeds not used to make mortgages and mortgage principal payments must be used to redeem outstanding bonds.

Sunset

The authority of State and local governments to issue tax-exempt mortgage subsidy bonds is scheduled to terminate on December 31, 1989.

Mortgage credit certificates

In general

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 (not to exceed $2,000 per year) 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. MCC's are generally subject to the same eligibility and targeted area requirements as qualified mortgage bonds.

Sunset

Mortgage credit certificates are scheduled to sunset with respect to nonissued mortgage subsidy bonds elected after December 31, 1989.

Explanation of Proposal

Qualified mortgage bonds and the mortgage credit certificates program would be extended for two years (bonds issued and MCCs issued pursuant to elections to trade-in State bond volume limitations, after December 31, 1989, and before January 1, 1992).

Effective Date

The proposal would be effective on the date of enactment.

4. Qualified Small-Issue Manufacturing Bonds

Present Law

Interest on certain small issues of private activity bonds is exempt from tax if at least 95 percent of the net proceeds of the bonds is to be 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. 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, certain previous small issues (and in the case of the $10-million limitation, capital expenditures during a 6-year period) are taken into account.

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.

The aggregate amount of qualified small-issue bond financing for first-time farmers 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.

To issue a qualified bond, the issuer must receive an allocation from the State private activity volume cap. Authority to issue qualified small-issue bonds expires December 31, 1989.

Explanation of Proposal

The authority to issue small-issue bonds would be extended for two years (through December 31, 1991).

Effective Date

The proposal would be effective on the date of enactment.

5. Business Energy Tax Credits

Present Law

Nonrefundable business energy tax credits of 10 percent are allowed for geothermal and business solar energy property. These tax credits are scheduled to expire after December 31, 1989.

The expiration date for these credits was extended from December 31, 1988, to December 31, 1989, in the Technical and Miscellaneous Revenue Act of 1988. Earlier, these tax credit rates were extended through 1988 in the Tax Reform Act of 1986.

Explanation of Proposal

The nonrefundable 10-percent energy credits for business solar energy and geothermal property would be extended for two years, through December 31, 1991, at the present 10-percent tax credit rate.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1989.

B. Permanent Extensions

1. Low-Income Rental Housing Tax Credit

Present Law

Present law provides a credit to owners of residential rental property used for low-income housing. The amount of the credit is determined as a percentage of the qualified basis of the housing units serving the low-income tenants. For buildings placed in service after 1987, the credit percentages are adjusted monthly to provide a credit with a present value equal to 70 percent of the qualified basis of the building. In the case of acquisition costs of existing housing and of newly constructed or rehabilitated housing receiving certain Federal subsidies (e.g., financed by the sale of tax-exempt bonds), monthly adjustments to the credit percentage are made to provide a credit with a present value equal to 30 percent of the qualified basis of the building.

The credit generally is allowed in equal annual amounts during the first 10 years after the qualified property is placed in service. Unless the qualified property continuously complies with requirements for low-income tenants and other credit requirements for a period of 15 years after it is placed in service, all or part of the credit may be recaptured during the 15-year compliance period.

Each State is assigned an annual credit volume limit of $1.25 per resident. The owner of eligible property is required to receive a credit allocation from the appropriate State or local government authority in order for the credit to be allowable, unless the property is financed with the proceeds of tax-exempt bonds subject to the State's private activity bond volume limitation.

The credit is scheduled to expire after December 31, 1989.

Explanation of Proposal

The proposal would make the low-income housing credit permanent. In all other aspects, the proposal follows the Subcommittee recommendation, with the following modifications:

(1) If at least 50 percent of the aggregate basis of a building and underlying land were financed with tax-exempt debt which received a State bond volume cap allocation, no State credit cap allocation would be required for the building.

(2) Community Development Block Grants would not be treated as Federal subsidies for purposes of determining the permissible present value credit.

(3) The permissible present value credit for projects receiving section 8 project-based assistance would be determined as under present law.

(4) Projects receiving section 8 moderate rehabilitation assistance would be eligible for no more than a 30-percent present value credit.

(5) The general definition of "substantial rehabilitation" would be modified to be the greater of $3,000 per low-income unit or 10 percent of unadjusted basis. An additional exception from the general rule would be provided for those federally-assisted buildings described in the Subcommittee's recommended additional exception to the 10-year placed-in-service rule. The acquisition costs of such buildings, the transfer of which is subject to HUD or FmHA approval, would be eligible for the 30-percent present value credit if the amount of rehabilitation undertaken were at least $2,000 per low-income unit.

However, the rehabilitation expenditures would be ineligible for any credit allocation unless they were "substantial" (exceeded the greater of $3,000 per low-income unit or 10 percent of unadjusted basis). If the rehabilitation expenditures were substantial, such expenditures would be eligible for the 70-percent present value credit.

(6) The 15-year credit period proposed by the Subcommittee, together with the associated penalty provision, would be an alternative to the present law 10-year credit period and associated recapture provisions. The discount rate for the determination of the credit present value for the 15-year credit period would be adjusted to reflect the longer period.

(7) The determination of whether a tenant satisfies the income limitations applicable to rent-restricted units would be made as under present law, based on actual family size. The gross rent limitation associated with a rent-restricted unit would be determined based on an assumed family size, as provided in the Subcommittee recommendation.

(8) States would be required to give consideration to available Federal subsidies committed to a project and to adjust the amount of credit allocated to the project to take such subsidies into account.

(9) States would be required to give first priority to those projects as to which the highest percentage of the

credit dollar would be used for project costs, not including the costs of intermediaries.

(10) State housing credit agencies would be required to notify the chief executive officer (if there is such an officer) of the local jurisdiction within which the project is located and provide him or her a reasonable opportunity for comment on the project.

(11) The provisions of the Subcommittee proposal limiting the nonprofits which would be eligible for the credit cap set-aside for nonprofits would be deleted.

(12) The tenants in a building would be given the right of first refusal (with one year's notice) to purchase the building should the owner decide to sell it after the end of the compliance period. The purchase price would be the sum of: (a) either assumption of the existing debt (not including debt incurred within the 5 years immediately preceding the sale) or an amount equal to such debt, (b) an amount equal to all taxes due by the owner on sale, and (c) a Federal tax gross-up amount.

(13) The provisions of the Subcommittee proposal relating to the eligibility of certain job training program participants, the treatment of trusts and estates, the pro rata rule upon transfer of property, and the provision of regulatory authority for the correction of errors in the allocation process are not included in this proposal. As technical corrections, they may be considered separately.

Effective Date

The proposal would generally be effective with respect to housing credit dollar amounts allocated from State housing credit ceilings for calendar years after 1989. For projects not subject to the credit allocation limits, the proposal would generally apply to buildings placed in service after December 31, 1989.

2. Research and Experimentation Tax Credit

Present Law

Incremental credit

General rule.-- A 20-percent tax credit is allowed for qualified research expenditures incurred by a taxpayer in carrying on a trade or business. Except for certain university basic research payments, the credit applies only to the extent that the taxpayer's qualified research expenditures for the current taxable year exceed the average amount of the taxpayer's yearly qualified research expenditures in the "base period," meaning the preceding three taxable years.

The credit is scheduled to expire after December 31, 1989.

Base limitation.--The amount of base-period research expenditures is treated as equal to at least 50 percent of the taxpayer's qualified research expenditures for the current year.

Trade or business limitation.--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.

Eligible expenditures.--Research expenditures eligible for the 20-percent incremental credit consist of (1) "in-house" expenditures by 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.

Aggregation rules and changes in business ownership.--To prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related persons, research expenditures of the taxpayer are aggregated with research expenditures of certain related persons for purposes of computing any allowable credit.

Special rules apply for computing the credit when a business changes hands, under which qualified research expenditures for periods prior to the change of ownership generally are treated as transferred with the trade or business which gave rise to those expenditures.

University basic research credit

In addition to the 20-percent incremental credit, there is a 20-percent tax credit for certain corporate expenditures for university basic research. This credit applies to the excess of (1) 100 percent of corporate cash expenditures (including grants or contributions) paid for university basic research over (2) the sum of (a) 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.

This credit also is scheduled to expire after December 31, 1989.

Relation of credit to section 174 deduction

For taxable years beginning after 1988, the amount of any deduction allowable to a taxpayer under section 174 or any other provision for qualified research expenditures is reduced by an amount equal to 50 percent of the taxpayer's research credit determined for that year.

Explanation of Proposal

Incremental credit: sales ratio R&E tax credit

General rule

A 20-percent tax credit would be allowed to the extent that a taxpayer's qualified research expenditures for the current year exceed its base amount for that year. The credit would be made permanent.

The base amount for the current year would be computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of taxpayer's gross receipts for the three preceding years.

Fixed-base percentage

Existing firms.--If a taxpayer incurred qualified R&E expenses and had gross receipts[4] during at least three years between 1983 and 1988, then its "fixed-base percentage" would be the ratio that its total qualified R&E expenses for any five years selected by the taxpayer during the 1983-88 period

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[4] The Treasury Department would be authorized to prescribe regulations providing that de minimis amounts of qualified R&E expenses and gross receipts may be disregarded.

bears to its total gross receipts for the five years selected (subject to a maximum ratio of .20, as described below).

Start-up companies.--If a taxpayer did not incur qualified R&E expenses and have gross receipts during at least three years between 1983-1988, then for each of its first five taxable years after 1989 in which it incurs qualified R&E expenses, the taxpayer would be assigned a fixed-base percentage of .03.

After its first five taxable years after 1989 in which it incurs qualified R&E expenses, a start-up firm's fixed-base percentage would be computed as follows: (1) for the firm's sixth year, its fixed-base percentage would be equal to one-third of its average research-to-gross receipts ratio for the initial five-year period; (2) for the firm's seventh year, its fixed-base percentage would be equal to one-half of its average research-to-gross receipts ratio for the initial five-year period; (3) for the firm's eighth year, its fixed-base percentage would be equal to two-thirds of its average research-to-gross receipts ratio for the initial five-year period; and (4) after a firm's eighth year, its fixed-base percentage would be equal to its average research-to-gross receipts ratio for the initial five-year period.

Maximum fixed-base percentage.--A taxpayer's fixed-base percentage would not exceed .20.

Base limitation

As under current law, a taxpayer's base may not be less than a certain percentage of current-year qualified R&E expenditures. The base limitation percentage would be 50 percent for 1990; 55 percent for 1991; 60 percent for 1992; 65 percent for 1993; 70 percent for 1994; and 75 percent for 1995 and later years.[5]

Trade or business limitation

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

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[5] Start-up firms (i.e., firms deemed to have a fixed-base percentage of .03) would be subject to a base limitation of 65 percent for 1990-1993, 70 percent for 1994, and 75 percent for 1995 and subsequent years.

Consistent treatment of R&E expenses

Research expenses taken into account in computing a taxpayer's fixed-base percentage would have to be treated on a basis which is consistent with the determination of qualified research expenses for the current year.

Treasury Department study

The Treasury Department would be required to conduct a study during each 5-year period beginning on January 1, 1990, to determine whether revenue losses from the credit are consistent with the projections and to analyze the effectiveness of the credit in promoting research.

Eligible expenditures

Same as under present law.

Aggregation rules and changes in business ownership

Same as under present law, with the modification that when a business changes hands, qualified research expenses and gross receipts for periods prior to the change of ownership would be treated as transferred with the trade or business which gave rise to those expenditures or receipts for purposes of recomputing a taxpayer's fixed-base percentage.

University basic research credit

The university basic research credit would be permanently extended.

Relation of credit to section 174 deduction

The amount of any deduction allowable to a taxpayer under section 174 or any other provision for qualified research expenditures would be reduced by an amount equal to 100 percent of the taxpayer's research credit determined for that year.

The proposal would clarify that research expenses are deductible under section 174 only to the extent that they are reasonable under the circumstances.

Effective Date

The proposal would be effective after December 31, 1989.

3. Allocation and Apportionment of Research Expenses

Present Law

Computation of the foreign tax credit requires the taxpayer to distinguish between taxable income from U.S. sources and taxable income from foreign sources, and thus to allocate and apportion deductions among items of U.S.-source and foreign-source gross income. Treasury regulations prescribe detailed methods for allocating and apportioning research and experimental (R&D) expenses.

The R&D allocation regulation was suspended in part by a succession of statutes, effective for taxable years beginning after August 13, 1981, and on or before August 1, 1987, as well as for each taxpayer's first taxable year beginning after August 1, 1987. In taxable years beginning after August 13, 1981 and on or before August 1, 1986, all U.S.-incurred R&D expenses were allocated to U.S.-source income. In taxable years beginning after August 1, 1986 and on or before August 1, 1987, 50 percent of such expenses (other than amounts incurred to meet certain legal requirements, and thus allocable to one geographic source) were allocated to U.S.-source income, with the remainder allocated and apportioned either on the basis of sales or gross income.

Expenses incurred during a taxpayer's first taxable year beginning after August 1, 1987 were given bifurcated treatment. Generally, for one third of the year's R&D expenses (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 was allocated to U.S.-source income, 64 percent of foreign-incurred R&D expenses was allocated to foreign-source income, and the remainder of R&D expenses was 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. Generally, for the other two thirds of the year's R&D expenses, the R&D allocation regulation applied.

Explanation of Proposal

Under the proposal, taxpayers would allocate 64 percent of expenses for R&D conducted in the United States to U.S.-source income, and would allocate 64 percent of expenses for R&D conducted outside the United States to foreign-source income. The remainder of such expenses would be apportioned on the basis of either 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 if the sales method is used.

Effective Date

The provision would be effective for taxable years beginning after August 1, 1989.

III. MEDICARE CATASTROPHIC INSURANCE PROVISIONS

Lower Supplemental Premium Rates

Present Law

The Medicare Catastrophic Coverage Act of 1988 expanded Medicare benefits and, as part of the financing mechanism, introduced the supplemental premium (sec. 59B). The supplemental premium is payable by any individual who is eligible for Part A of Medicare for at least 6 months during the year, who has income tax liability for the year of at least $150, and who resides in one of the 50 states or the District of Columbia. Subject to a maximum premium payable by an individual, the annual premium can be calculated by multiplying the individual's adjusted income tax liability times the supplemental premium percentage.

The supplemental premium rate and maximum premium payment are set by law for years 1989 through 1993, and are presented in the table below. The supplemental premium rate and maximum supplemental premium are adjusted by formula after 1993.

Year	Supplemental Premium Percentage Rate	Maximum Annual Supplemental Premium
1989	15%	$800
1990	25	850
1991	26	900
1992	27	950
1993	28	1,050

Explanation of Proposal

The proposal would reduce the rate of the supplemental premium to 5 percent in 1989, 9 percent in 1990 through 1992, and 10 percent in 1993.

Effective Date

The proposal would be effective as if included in the Medicare Catastrophic Coverage Act of 1988.

IV. ELIMINATE FROM CHAIRMAN'S MARK REPEAL OF REMAINING 10-PERCENT PERSONAL INTEREST DEDUCTION FOR 1990

Present Law

Under present law, personal interest is not deductible. Personal interest is any interest, other than interest incurred or continued in connection with the conduct of a trade or business (other than the trade or business of performing services as an employee), investment interest, or interest taken into account in computing the taxpayer's income or loss from passive activities for the year. Qualified residence interest is not subject to the limitation on personal interest.

The personal interest limitation is phased in for taxable years after 1986, and becomes fully effective for taxable years beginning in 1991 and thereafter. The applicable percentages under the phasein rule are 35 percent in 1987, 60 percent in 1988, 80 percent in 1989, 90 percent in 1990, and 100 percent in 1991 and thereafter. Thus, in 1990, when the applicable percentage is 90 percent, only 10 percent of personal interest would be deductible.

On July 13, 1989, the Committee voted to eliminate the percentage phasein for 1990, so that 100 percent (rather than 90 percent) of personal interest would be nondeductible in 1990.

Explanation of Proposal

The proposal would restore the percentage phasein under the personal interest limitation for 1990. Thus, under the proposal, as under present law, the applicable percentage under the personal interest phasein rule would be 90 percent; therefore, 10 percent of personal interest would be deductible in 1990.

Effective Date

The proposal would be effective for taxable years beginning in 1990.

V. SUBCOMMITTEE-RELATED ITEMS

A. Simplification of the Corporate Alternative Minimum Tax

Present Law

Under present law, corporations are subject to an alternative minimum tax which is payable, in addition to all other tax liabilities, to the extent that it exceeds the corporation's regular income tax owed. The tax is imposed at a flat rate of 20 percent on alternative minimum taxable income in excess of a phased-out exemption amount. Alternative minimum taxable income is the corporation's taxable income increased by the corporation's tax preferences and adjusted by determining the tax treatment of certain items in a manner which negates the exclusion or deferral of income resulting from the regular tax treatment of those items.

Adjustments and preferences are provided for accelerated depreciation, mining exploration and development costs, certain long-term contracts, pollution control facilities, certain installment sales, Merchant Marine Capital Construction Funds, special insurance deductions, percentage depletion, excess intangible drilling costs over 65 percent of oil and gas income, certain debt reserves of financial institutions, tax-exempt interest on certain newly issued private activity bonds, and charitable deductions of appreciated property.

In addition, in computing alternative minimum taxable income, for taxable years beginning before 1990, alternative minimum taxable income is increased by one-half of the amount by which the corporation's pre-tax book income exceeds the corporation's alternative minimum taxable income (determined without regard to this adjustment and without regard to net operating losses). Book income generally is the amount that the corporation discloses on its financial statements prepared for creditors, shareholders, regulatory purposes, and so forth.

For taxable years beginning after 1989, the adjustment for book income no longer applies and, instead, alternative minimum taxable income is increased by an amount equal to 75 percent of the amount by which adjusted current earnings (ACE) exceed alternative minimum taxable income (before this adjustment). In general, adjusted current earnings means alternative minimum taxable income as computed above with additional adjustments. These adjustments generally follow the rules presently applicable to corporations in computing their earnings and profits. Thus, for example, depreciation is computed using the alternative depreciation system used for earnings and profits purposes. For depreciation on property placed in service before 1990, the remaining ACRS basis (remaining minimum tax basis for property to which the new ACRS system applies) is recovered over the remaining ADR midpoint life. In addition, the amount of the deduction for certain items such as depreciation, depletion, intangible drilling costs, and mining exploration and development costs cannot exceed the corporation's book treatment of the item, based on a present value computation.

Legislative Background

H.R. 1761, as introduced by Chairman Rostenkowski, would have simplified the alternative corporate minimum tax for taxable years beginning after 1989 by repealing the adjusted current earnings (ACE) preference as a separate preference and by integrating its component items into the regular minimum tax as separate preferences. Thus, those ACE preferences integrated into the regular minimum tax would have become full preferences rather than 75-percent preferences, as under present law. In addition, H.R. 1761, as originally introduced, would have modified the computation of certain ACE preferences such as depreciation.

The recommendations of the Subcommittee on Select Revenue Measures generally followed H.R 1761 as originally introduced, but would have applied the 120 percent declining balance method of depreciation for certain property placed in service before 1990. The Subcommittee also recommended making several technical changes to certain ACE adjustments.

Explanation of Proposal

Basic proposal

The proposal would retain the present-law ACE system (*i.e.*, as a 75-percent adjustment) with modifications. The proposal would eliminate all references to the taxpayer's book income treatment of items. Thus the depreciation system would be the same as under present-law ACE except that the book method would not be taken into account. The proposal also would delete the use of the taxpayer's book method for purposes of computing the taxpayer's ACE adjustment for depletion, intangible drilling costs, and mining exploration and development costs.

Technical amendments

The proposal would adopt the following technical changes recommended by the Subcommittee on Select Revenue Measures:

Gain on installment sales with respect to which interest is paid at the tax underpayment rate would be allowed minimum tax installment sale treatment since appropriate interest is being paid for the right to defer payment of the tax. The

Subcommittee recommendation would be modified to provide that the interest charge on sales of timeshares and residential lots would be conformed to the general regular tax rules relating to the payment of interest on installment sales by nondealers, except that the $5 million or $150,000 exceptions of section 453A would not apply. The current payment of the interest charge would be deferred for the first two years from the date of the sale. If the buyer did not default by the end of the second year after the date of sale, the accumulated deferred interest charge would be due at such time.

The regular tax rules relating to the treatment of discharge of indebtedness income would apply for purposes of the minimum tax. Thus, bankrupt and insolvent corporations would be required to reduce minimum tax attributes such as net operating losses but would not be required to pay a minimum tax currently as a result of the discharge of indebtedness.

The regular tax principles (sec. 263A) rather than the earnings and profits rules would apply for purposes of capitalizing certain expenses. Thus, corporations would benefit from the de minimis exceptions available under section 263A.

The rules relating to the amortization of intangible drilling costs would provide for 60-month amortization beginning in the month in which the costs are paid or incurred (instead of when production commences).

The rules under present-law ACE relating to the treatment of certain changes of ownership would be made inapplicable to changes of ownership occurring in taxable years beginning before 1990.

The special treatment of annuities would be deleted as unnecessary by reason of the exceptions added by the Technical and Miscellaneous Revenue Act of 1988.

The Secretary of the Treasury would be directed to provide guidance on those items of earnings and profits which are included in the ACE adjustment.

Several nonsubstantive drafting simplifications would be made.

<u>Effective Date</u>

The proposal would apply to taxable years beginning after December 31, 1989.

B. Modification of Rehabilitation Tax Credit Under the Passive Loss Rule

Present Law

Under present law, a rehabilitation tax credit is provided for expenditures incurred in rehabilitation of certified historic structures and certain nonresidential buildings placed in service before 1936. A 20-percent credit is provided in the case of certified historic structures, and a 10-percent credit is provided in the case of qualified rehabilitated buildings (other than certified historic structures) that are nonresidential and that were originally placed in service before 1936.

Under the passive loss rules, credits from passive activities generally are limited to the tax attributable to the passive activities. The passive loss rules apply to individuals, estates, trusts, and personal service corporations. A special rule limits the use of passive activity losses and credits against portfolio income in the case of closely held corporations.

A special rule is provided for passive activity losses and credits attributable to rental real estate activities, allowing up to $25,000 of losses (to the extent they exceed income from passive activities) from rental real estate activities in which the taxpayer actively participates. The $25,000 allowance also applies to low-income and rehabilitation credits (on a deduction equivalent basis), regardless of whether the taxpayer claiming the credit actively participates in the rental real estate activity generating the credit. In addition, the adjusted gross income phaseout range for the $25,000 deduction equivalent amount for these credits is from $200,000 to $250,000 (rather than the phaseout range of $100,000 to $150,000 that is generally applicable under the $25,000 allowance).

Explanation of Proposal

The proposal would modify the present-law application of the passive loss restrictions to the rehabilitation tax credit by removing the adjusted gross income limitations on the $25,000 deduction equivalent allowance of the credit with respect to rental real estate activities. This proposal was ordered favorably reported by the Subcommittee on Select Revenue Measures on June 13, 1989.

Effective Date

The proposal would be effective for taxable years ending after December 31, 1989, for property placed in service after that date. In addition, if the property is held through a partnership or other pass-through entity, the taxpayer's interest in the partnership or other pass-through entity must have been acquired after December 31, 1989.

C. H.R. 1233, THE CARIBBEAN BASIN ECONOMIC RECOVERY EXPANSION ACT OF 1989

Section 101 repeals the September 30, 1995 termination date on duty-free treatment under the CBI.

Section 102 establishes a statutory Guaranteed Access Level program and duty-free treatment for imports of apparel and other textile products assembled in CBI countries of U.S. cut and formed fabric or of certain foreign fabric, and grants 50 percent duty reductions on imports of textiles and apparel articles subject to import quotas. Section 102 also grants 50 percent duty reductions on imports of footwear, except leather footwear, and handbags, luggage, flat goods, work gloves, and leather-wearing apparel from CBI countries currently exempt from duty-free treatment.

Section 103 includes internationally-recognized worker rights conditions for the designation of CBI countries that are consistent with the existing standards under the Generalized System of Preferences (GSP) program, and requires the President to conduct a biennial review of CBI eligible countries based on all statutory designation criteria.

Section 104 requires a report by the President to the Congress every 3 years on the operation of the CBI program.

Section 105 expresses the sense of the Congress on the need for special efforts to improve the ability of the Eastern Caribbean countries and Belize to benefit from the CBI.

Section 111 establishes a guaranteed minimum floor at the 1989 level for sugar imports from CBI countries under the U.S. sugar quota program, requires the reallocation of unused and suspended or terminated sugar quotas to CBI countries, and authorizes trade agreement compensation if these actions violate U.S. international obligations.

Section 112 increases the duty-free tourist allowance for U.S. residents returning from CBI countries from $400 to $600 and by 1 additional liter of alcoholic beverages if produced in the region, and increases the duty-free allowance for tourists returning from U.S. insular possessions from $800 to $1,200.

Section 113 grants duty-free and quota-free treatment to articles assembled or processed in CBI countries wholly of U.S. components or ingredients, except water.

Section 114 authorizes the President to proclaim, effective January 1, 1991, new rules for determining the origin of articles for duty-free CBI treatment, subject to consultation and reporting requirements and a 90-day Congressional layover period.

Section 115 creates an exception to the general rule for cumulation of imports to determine material injury to domestic industries in antidumping and countervailing duty investigations if CBI imports are the subject of the investigation.

Section 116 establishes several different criteria for the dutyfree treatment of ethanol imports from CBI countries and U.S. insular possessions.

Section 117 amends the GSP statute to specifically require "substantial transformation" of an eligible article in a beneficiary developing country as a condition for duty-free treatment, in conformity with the existing CBI requirement.

Section 201 requires the Agency for International Development to establish, in cooperation with States and the private sector, a program of scholarship assistance for students from CBI countries to study in the United States in subject areas critical to the development needs of their countries. The Federal share would be funded under the Foreign Assistance Act of 1961.

Section 202 expresses the sense of the Congress that U.S. Government agencies should assign a high priority to projects that promote tourism in the Caribbean, and requires the Secretary of Commerce to complete a study on tourism development strategies for the region.

Section 203 requires the U.S. Customs Service to carry out preclearance operations during fiscal years 1990 and 1991 at a site in the Caribbean appropriate for testing the extent that preclearance operations can assist in tourism development. The Commissioner must report to the Congress on the results of the pilot program.

VI. REVENUE-RAISING OFFSETS

A. Excise Tax on Ozone-Depleting Chemicals

Present Law

The use or manufacture of chemicals which deplete the ozone layer is not subject to Federal tax under present law.

Explanation of Proposal

The proposal would assess an excise tax on the sale or use by a manufacturer of certain ozone-depleting chemicals and on the import into the United States of such chemicals or products containing such chemicals. Ozone-depleting chemicals include: chlorofluorocarbons ("CFCs") (which generally are used as refrigerants, foam blowing agents, and solvents); carbon tetrachloride; methyl chloroform; methylene chloride; and halons.[6] The Secretary of the Treasury may add or remove substances from the list of ozone-depleting chemicals consistent with the purposes of the proposal.

The amount of tax would be determined by multiplying a base tax amount by an "ozone-depleting factor." The ozone-depleting factor would reflect the potential ozone depletion which would result from one kilogram of a given chemical compared to the ozone depletion which results from one kilogram of CFC-11 (trichlorofluoromethane).[7] The Secretary may prescribe ozone-depleting factors which will apply in lieu of those specified in the statute. For calendar year 1990, the base tax amount would be $1.00 per pound of ozone-depleting chemical; for 1991, the base tax amount would be $2.00 per pound; for 1992, the base tax amount would be $3.00 per pound; for 1993, the base tax amount would be $4.00 per pound; and for 1994 and after, the base tax amount would be $5.00 per pound. The base tax amount would be indexed for inflation which occurs after 1989.

Effective Date

The proposal would be effective for ozone-depleting chemicals produced in or imported into the country after December 31, 1989. In addition, a floor stocks tax is imposed on ozone-depleting chemicals held by a dealer for sale on January 1, 1990.

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[6] The statutory language would enumerate specific chemicals subject to tax. This list is a summary.

[7] CFC-11 is assigned an ozone depleting factor of 1.0.

B. Treatment of Policyholder Dividends of Mutual Life Insurance Companies

Present Law

Under present law, both stock and mutual life insurance companies are allowed a deduction for the amount of policyholder dividends paid or accrued during any taxable year. The amount of the deduction for policyholder dividends of a mutual life insurance company, however, is reduced by a differential earnings amount, which reflects the determination of Congress in 1984 that the policyholder dividends of a mutual life insurance company include a return of earnings to policyholders as owners of the company.

The differential earnings amount is determined by multiplying the average equity base of a mutual life insurance company by the differential earnings rate for the taxable year. The differential earnings rate is the excess of an imputed earnings rate for the taxable year over the average mutual earnings rate for the second calendar year preceding the calendar year in which the taxable year begins. The differential earnings amount is recomputed in a subsequent taxable year in order to take into account the average mutual earnings rate for the calendar year in which the taxable year begins.

Explanation of Proposal

As a stopgap measure for taxable years beginning before 1992, the present-law limitation on the deductibility of policyholder dividends of mutual life insurance companies (section 809) would be suspended and replaced by a revised limitation. No other provision of present law would be suspended or modified during this period. In the event that Congress does not enact superseding legislation that provides otherwise, the present-law limitation (section 809) would apply to taxable years beginning after 1991.

Under the revised limitation, the deduction for policyholder dividends of mutual life insurance companies (and certain life insurance companies owned by mutual life insurance companies) would be limited to 70 percent of the amount of otherwise deductible policyholder dividends. The present-law provision which requires a recomputation of the differential earnings amount in a subsequent year would continue to apply with respect to any taxable year to which the present-law limitation applies.

Effective Date

The proposal would apply to taxable years ending after July 17, 1989, and beginning before January 1, 1992, except that for the taxable year that includes July 17, 1989, the proposal would apply only to the amount of policyholder dividends that are allocable on a pro-rata basis to the portion of the taxable year that occurs after July 17, 1989. The remainder of the policyholder dividends for the taxable year that includes July 17, 1989, would be reduced by an allocable portion of the differential earnings amount.

C. Extension of the Telephone Excise Tax

Present Law

A 3-percent excise tax is imposed on amounts paid for local and toll (long-distance) telephone service and teletypewriter exchange service (sec. 4251). The tax is collected by the provider of the service from the consumer (business and personal service). The tax is scheduled to expire after December 31, 1990.

The 3-percent telephone excise tax was last extended for three years (1988-1990) in the Omnibus Budget Reconciliation Act of 1987. The 3-percent tax was previously extended for two years (1986-1987) in the Deficit Reduction Act of 1984.

Explanation of Proposal

The 3-percent telephone excise tax would be made permanent.

Effective Date

The proposal to extend the telephone excise tax would be effective on January 1, 1991.

D. Modification of Tax Collection Period for the Air Passenger Transportation Ticket Excise Tax

Present Law

Imposition of tax.--An 8-percent excise tax on air passenger transportation is imposed by Code sections 4261(a) and (b). Taxes collected under these provisions are deposited in the Airport and Airway Trust Fund.

Collection of tax.--The air passenger transportation 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 depositary within 3 banking days after the end of the semi-monthly period for which the tax is considered collected.

Explanation of Proposal

Modification of collection period.--Under the proposal, the 8-percent passenger ticket tax for a semi-monthly period would be considered collected during the first week of the second following semi-monthly period. The tax would be required to be deposited within 3 banking days after the end of the week for which such tax is considered to be collected.

Effective Date

The proposal would be effective with respect to taxes considered collected for semi-monthly periods beginning after June 30, 1990.