

[JOINT COMMITTEE PRINT]

**DESCRIPTION OF TAX PROPOSALS
CONTAINED IN THE
"CONTRACT WITH AMERICA"
(H.R. 6, H.R. 9, H.R. 8, and H.R. 11)**

PREPARED FOR THE USE
OF THE
SENATE COMMITTEE ON FINANCE

BY THE STAFF
OF THE
JOINT COMMITTEE ON TAXATION



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INTRODUCTION

This pamphlet,¹ prepared by the staff of the Joint Committee on Taxation for the use of the Senate Committee on Finance provides a description of present law and the tax proposals in the House Republican's proposed "Contract With America" (Contract). The Contract was introduced by the House leadership when the 104th Congress convened on January 4, 1995, and includes four bills which contain various tax proposals: H.R. 6 ("American Dream Restoration Act"); H.R. 9 ("Job Creation and Wage Enhancement Act"); H.R. 8 ("Senior Citizens' Equity Act"); and H.R. 11 ("Family Reinforcement Act").

¹This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of Tax Proposals Contained in the "Contract With America"* JCS-2-95, February 7, 1995. (This pamphlet is the same as JCS-1-95, except for the cover and introduction pages.)

I. AMERICAN DREAM RESTORATION ACT (H.R. 6)

A. Family Tax Credit (sec. 2 of the bill and sec. 35 of the Code)

Present Law

Present law does not provide tax credits based solely on the number of dependent children. Taxpayers with dependent children, however, generally are able to claim a personal exemption for each of these dependents. The total amount of personal exemptions is subtracted (along with certain other items) from adjusted gross income (AGI) in arriving at taxable income. The amount of each personal exemption is \$2,500 for 1995, and is adjusted annually for inflation. The amount of the personal exemption is phased out for taxpayers with AGI in excess of \$114,700 for single taxpayers, \$143,350 for heads of household, and \$172,050 for married couples filing joint returns.

In addition, eligible low-income workers are able to claim a refundable earned income tax credit (EITC). The amount of the credit an eligible taxpayer may claim depends upon whether the taxpayer has one, more than one, or no qualifying children, and is determined by multiplying the credit rate by the taxpayer's earned income up to an earned income threshold. The maximum amount of the credit is the product of the credit rate and the earned income threshold. In 1995, the maximum credit is \$3,112 for taxpayers with more than one qualifying child, \$2,093 for taxpayers with one qualifying child, and \$314 for taxpayers with no qualifying children. For taxpayers with earned income (or AGI, if greater) in excess of the phaseout threshold, the credit amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the phaseout threshold. The credit is not allowed if earned income (or AGI, if greater) exceeds the phaseout limit. In 1995, the phaseout limit is \$26,676 for taxpayers with more than one qualifying child, \$24,388 for taxpayers with one qualifying child, and \$9,234 for taxpayers with no qualifying children.

Description of Proposal

The bill would provide taxpayers with a maximum refundable tax credit of \$500 for each qualifying child.

The credit would be phased out ratably for taxpayers with AGI over \$200,000, and would be fully phased out at AGI of \$250,000. In calendar years beginning after 1996, the maximum credit amounts and beginning point of the phaseout range would be indexed annually for inflation.

To be a qualifying child, an individual would have to satisfy a relationship test, a residency test, and an age test. The individual

would satisfy the relationship test if the individual is a son, stepson, daughter, or stepdaughter of the taxpayer, a descendent of a son or daughter of the taxpayer, or a foster or adopted child of the taxpayer. A foster child would be defined as an individual whom the taxpayer cares for as the taxpayer's own child. An adopted child would include a child who is legally adopted or who is placed with the taxpayer by an authorized placement agency for adoption by the taxpayer. If the qualifying child is married at the close of the taxpayer's taxable year, the taxpayer generally must be entitled to a dependency deduction for the taxable year with respect to such qualifying child in order to claim the credit.

An individual would satisfy the residency test if the individual has the same principal place of abode as the taxpayer for more than half the taxable year (the entire year for foster children). The determination of whether the residency requirement is met would be made under rules similar to those applicable with respect to whether an individual meets the requirements for head-of-household filing status. Thus, for example, certain temporary absences due to education or illness would be disregarded for purposes of determining whether the child had the same principal place of abode as the taxpayer for over half the year. Also, the residence would have to be in the United States.

An individual would satisfy the age test if the individual has not attained the age of 18 as of the close of the calendar year in which the taxable year of the taxpayer begins.

The maximum amount of credit, regardless of the number of qualifying children, could not exceed an amount equal to the sum of: (1) the taxpayer's income tax liability (net of applicable credits), and (2) the taxpayer's Railroad Retirement Tier 1 tax and Social Security tax (SECA and the employee and employer share of FICA), less the taxpayer's allowable EITC amount. For these purposes, Social Security tax would not include any amounts to the extent the taxpayer is entitled to a special refund under section 6413(c) (relating to overpayment of certain employment taxes). Also, any amounts paid pursuant to an agreement under section 3121(l) (relating to agreements entered into by American employers with respect to foreign affiliates) would be treated as Social Security tax for purposes of this credit.

The bill would provide that couples who are married at the end of the taxable year must file a joint return to receive the credit unless they lived apart for the last six months of the taxable year and the individual claiming the credit (1) maintained as his or her home a household for the qualifying child for more than one-half the taxable year and (2) furnished over one-half the cost of maintaining that household in that taxable year.

Effective Date

The provision would be effective for taxable years beginning after December 31, 1995.

B. Credit to Reduce the Marriage Penalty (sec. 3 of the bill and new sec. 23 of the Code)

Present Law

A married couple generally is treated as one tax unit that must pay tax on the unit's total taxable income. Although married couples may elect to file separate returns, the rate schedules and provisions are structured so that filing separate returns usually results in a higher tax than filing joint returns. Other rate schedules apply to single persons and to single heads of household.

A "marriage penalty" exists when the sum of the tax liabilities of two unmarried individuals filing their own tax returns (either single or head of household returns) is less than their tax liability under a joint return (if the two individuals were to marry). A "marriage bonus" exists when the sum of the tax liabilities of the individuals is greater than their combined tax liability under a joint return.

While the size of any marriage penalty or bonus under present law depends upon the individuals' incomes, number of dependents, and itemized deductions, a general rule is that married couples whose earnings are split relatively evenly (between 50-50 and 70-30) suffer a marriage penalty. Married couples whose earnings are largely attributable to one spouse generally receive a marriage bonus.

Description of Proposal

Married couples who file a joint return and have a larger tax liability than if they were unmarried and filed individual returns would be eligible for a nonrefundable credit against their income tax liability. The amount of the credit would be determined by the Department of the Treasury so that the estimated reduction in revenues to the Treasury would not exceed \$2 billion per fiscal year. In no event would the credit for a particular taxpayer be larger than the size of the marriage penalty the couple would face without the provision.

Effective Date

The provision would be effective for taxable years beginning after the date of enactment.

C. Establishment of American Dream Savings Accounts (sec. 4 of the bill and sec. 408A of the Code)

Present Law

Under present law, an individual may make deductible contributions to an individual retirement arrangement (IRA) up to the lesser of \$2,000 or the individual's compensation if the individual is not an active participant in an employer-sponsored retirement plan (and, if married, the individual's spouse also is not an active participant in such a plan). If the individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the \$2,000 deduction limit is phased out over certain adjusted gross income (AGI) levels. The limit is phased out between \$40,000 and \$50,000 of AGI for married taxpayers, and between \$25,000 and \$35,000 of AGI for single taxpayers. An individual may make nondeductible IRA contributions to the extent the individual is not permitted to make deductible IRA contributions.

The amounts held in an IRA, including earnings on contributions, generally are not subject to tax until withdrawn. Amounts withdrawn prior to attainment of age 59½ are subject to an additional 10-percent early withdrawal tax, unless the withdrawal is due to death, disability, or is made in the form of certain periodic payments. A similar early withdrawal tax applies to distributions from tax-qualified pension plans, with an additional exception for distributions used to pay medical expenses that exceed 7.5 percent of AGI. This exception for distributions to pay extraordinary medical expenses does not apply to withdrawals from IRAs.

Description of Proposal

The bill would permit individuals to establish and maintain an American Dream Savings Account (ADS account) to which they can make nondeductible contributions. Contributions to an ADS account would be in addition to any contributions that can be made to an IRA under the present-law rules. An ADS account would be an IRA which is designated at the time of establishment as an ADS account. Qualified distributions from an ADS account would not be includible in income.

The maximum annual contribution that could be made to an ADS account would be the lesser of \$2,000 or the individual's compensation for the year. In the case of a married couple, the aggregate compensation of the couple would be taken into account in determining the maximum permitted contribution. Thus, for example, in 1996 both spouses in a married couple could each make an ADS contribution of \$2,000 (for a total contribution by the couple of \$4,000), provided the couple has at least \$4,000 in compensation. The \$2,000 contribution limit would be adjusted annually for inflation beginning after 1996. Inflation adjustments would be rounded to the nearest \$50.

Contributions to an ADS account could be made even after the individual for whom the account is maintained has attained age

70½, and the minimum distribution rules that apply to IRAs would not apply to ADS accounts.²

Qualified distributions from an ADS account would not be includible in gross income, nor subject to the additional 10-percent tax on early withdrawals. A qualified distribution would be a distribution that is made after the 5-taxable year period³ beginning with the first taxable year in which the individual made a contribution to an ADS account, and (2) which is (a) made on or after the date on which the individual attains age 59½, (b) made to a beneficiary (or to the individual's estate) on or after the death of the individual, (c) attributable to the individual's being disabled, or (d) a qualified special purpose distribution.

Qualified special purpose distributions would be distributions for the purchase or acquisition of a principal residence of a first-time homebuyer, for higher education expenses of the taxpayer, the taxpayer's spouse, or the taxpayer's child or grandchild, for medical expenses, or for long-term care insurance premiums.

Distributions from an ADS account other than qualified distributions would be includible in gross income under the rules applicable to distributions from IRAs and subject to the 10-percent tax on early withdrawals.

Distributions from ADS accounts could be rolled over tax free to another ADS account. In addition, amounts withdrawn from an IRA could be rolled over to an ADS account after December 31, 1995, and before January 1, 1998. The amount otherwise includible in gross income due to the IRA distribution would be included in gross income ratably over the 4-taxable year period beginning with the taxable year in which the distribution is made. The early withdrawal tax would not apply to such rollovers.

Effective Date

The provision would be effective for taxable years beginning after December 31, 1995.

² In general, the minimum distribution rules require that distributions from an IRA begin no later than age 70½. Tax penalties are imposed if minimum distributions are not made as required.

³ In the case of rollover contributions that are not from another ADS account, the 5-year holding period would begin on the date on which the rollover was made.

II. JOB CREATION AND WAGE ENHANCEMENT ACT (H.R. 9)

A. Capital Gains Reforms (Title I)

1. 50-percent capital gains deduction (sec. 1001 of the bill and secs. 1201 and 1202 of the Code)

Present Law

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of capital assets, the net capital gain is taxed as ordinary income, except that taxpayers other than corporations are subject to a maximum marginal rate of 28 percent of the net capital gain. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held more than one year.

A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, or (5) certain U.S. publications. In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances that would have been available under the straight-line method.

The Revenue Reconciliation Act of 1993 provided a 50-percent exclusion for gain from the sale of certain small business stock acquired at original issue and held for at least five years. One-half of the excluded amount is a minimum tax preference.

Prior to the enactment of the Tax Reform Act of 1986, individuals were allowed a deduction equal to 60 percent of net capital gain. This resulted in a maximum tax rate of 20 percent on such gains. Corporations were taxed a maximum rate of 28 percent on any net capital gain.

Capital losses are generally deductible in full against capital gains. In addition, taxpayers other than corporations may deduct capital losses against up to \$3,000 of ordinary income in each year. Capital losses in excess of the amount deductible are carried forward indefinitely in the case of individuals, and generally carried back three years and forward five years in the case of corporations. Prior to the Tax Reform Act of 1986, taxpayers other than corpora-

tions were required to use two dollars of long-term capital loss to offset each dollar of ordinary income.

Description of Proposal

The bill would allow all taxpayers (both individual and corporate) a deduction equal to 50 percent of net capital gain for the taxable year. The bill would repeal the present-law maximum 28-percent rate. Thus, the effective rate on the net capital gain of an individual in the highest (i.e., 39.6 percent) rate bracket would be 19.8 percent, and the effective rate for a corporation in the 35-percent bracket would be 17.5 percent.

The bill would repeal the provisions in the Revenue Reconciliation Act of 1993 providing a capital gain exclusion for sales of certain small business stock.

The bill would reinstate the rule in effect prior to the 1986 Tax Reform Act that required two dollars of the long-term capital loss of an individual to offset one dollar of ordinary income. The \$3,000 limitation on the deduction of capital losses against ordinary income would continue to apply.

Numerous conforming amendments would be made generally to reinstitute the capital gains deduction system in effect prior to the Tax Reform Act of 1986.

Effective Date

The provision generally would apply to taxable years ending after December 31, 1994.

For a taxpayer's 1994-95 fiscal year or for the 1995 calendar year of a taxpayer holding interests in one or more 1994-95 fiscal year pass-thru entities, the 50-percent capital gains deduction would apply to the lesser of (1) the net capital gain for the taxable year, or (2) the net capital gain determined by taking into account gain or loss properly taken into account for the portion of the taxable year on or after January 1, 1995. In the case of a taxpayer other than a corporation, any net capital gain not eligible for the 50-percent capital gains deduction would be subject to the present-law maximum rate of 28 percent. This generally has the effect of applying the 50-percent deduction to capital assets sold or exchanged (or installment payments received) on or after January 1, 1995, and, in the case of noncorporate taxpayers, subjecting gains from capital assets sold before that date to a maximum rate of 28 percent.

In the case of gain taken into account by a pass-thru entity (i.e., a RIC, a REIT, an S corporation, a partnership, an estate or trust, or a common trust fund), the date taken into account by the entity is the appropriate date for applying the rule in the preceding paragraph. Thus, gain taken into account by a fiscal-year pass-thru entity in 1994 which an owner takes into account on its calendar-year 1995 income tax return would not be eligible for the new capital gains deduction.

2. Indexing of basis of certain assets for purposes of determining gain or loss (sec. 1002 of the bill and new sec. 1022 of the Code)

Present Law

Under present law, the amount taken into account in computing gain or loss from the disposition of any asset is the sales price of the asset reduced by the taxpayer's basis in that asset. The taxpayer's basis generally is the taxpayer's cost in the asset adjusted for depreciation, depletion, and certain other amounts. No adjustment is allowed for inflation.

Description of Proposal

In general

The bill generally would provide for an inflation adjustment to (i.e., indexing of) the basis of certain assets (called "indexed assets") for purposes of determining gain or loss upon a sale or other disposition of such assets. Assets the basis of which would be eligible for the inflation adjustment generally would include corporate stock and tangible property that are capital assets or property used in a trade or business and are held by the taxpayer for more than one year. The inflation adjustment would be measured by increases in the Gross Domestic Product ("GDP") deflator occurring after December 31, 1994, regardless of whether the asset was acquired by the taxpayer prior to that date.

Indexed assets

The bill generally would provide for the indexing of corporate stock. For this purpose, options, warrants, or other contract rights with respect to stock would not be considered stock. The inflation adjustment would not apply to stock in an S corporation, or generally to stock in a foreign corporation.⁴ In addition, no inflation adjustment would be provided for preferred stock that does not participate in corporate growth to any significant extent.

The bill would provide for the indexing of the basis of tangible property (or any interest therein) that is a capital asset or property used in a trade or business. An indexed asset would not, however, include any mortgage or other creditor's interest in property. In addition, a lessor's interest in property subject to a net lease would not be an indexed asset. No property using neutral cost recovery would be an indexed asset. (See discussion in Part II.B., below, "Neutral Cost Recovery.")

The basis of debt would not be indexed. For example, in the case of a loan, a precise inflation adjustment would require the lender to deduct a loss from inflation and the borrower to report a gain. Similarly, the bill would exclude from indexing intangible assets, such as options, where there is an option writer and option buyer who have offsetting inflation adjustments.

⁴ See further discussion below relating to these entities.

Computation of inflation adjustment

The inflation adjustment under the bill would be computed by multiplying the taxpayer's adjusted basis in the indexed asset by the ratio of the GDP deflator for the calendar quarter in which the disposition takes place to the GDP deflator for the calendar quarter in which the asset was acquired by the taxpayer (or, if later, the calendar quarter ending on December 31, 1994). The inflation ratio would be rounded to the nearest one-thousandth. No adjustment would be made if the inflation ratio is one or less.

Indexing with respect to any asset would end at the time the asset is treated as disposed of for tax purposes. Thus, with respect to installment sales, the inflation adjustment to the seller would not take into account any periods after the sale is made. The purchaser would be entitled to inflation adjustments beginning with the date of purchase, even though the purchase price is not paid until a later date.

In computing the inflation ratio, periods of time for which an asset is not an indexed asset would not be taken into account. For example, if convertible debt is converted into common stock, the period prior to conversion would be disregarded in determining the inflation ratio applicable to the disposition of the common stock.

Special entities

RICs and REITs

In the case of a regulated investment company (RIC) or a real estate investment trust (REIT), the indexing adjustments provided generally would apply in computing the taxable income and the earnings and profits of the RIC or REIT. The indexing adjustments, however, would not apply in determining whether a corporation qualifies as a RIC or REIT.

In the case of shares held in a RIC or REIT, partial indexing would be provided by the bill based on the ratio of the value of indexed assets held by the entity to its total assets. This ratio would be determined every month. However, in the case of a REIT, an actual valuation would be required only once every three years because of the cost and difficulty of more frequent valuations. If the ratio of indexed assets to total assets exceeds 90 percent in any month, full indexing of the shares would be allowed for that month. If less than 10 percent of the assets are indexed assets in any month, no indexing would be allowed for that month for the shares.

Partnerships and S corporations, etc.

Under the bill, stock in an S corporation or an interest in a partnership would not be an indexed asset.⁵ This rule avoids the complexity that would result in determining the proper measure of the basis adjustment if indexing were to take into account the fluctuating basis of the S corporation stock or partnership interest attributable to earnings and distributions or to the frequently changing mix of assets (i.e., indexed assets and other assets) of the entity. Under the bill, the shareholder or partner would receive the benefit

⁵ An interest in a real estate mortgage investment conduit ("REMIC") also would not be an indexed asset, since a REMIC is not treated as a corporation for income tax purposes.

of the indexing adjustment to his or her stock or partnership interest to the extent the corporation or partnership disposes of indexed assets.⁶ Under the bill, any inflation adjustments at the entity level would flow through to the holders and result in a corresponding increase in the basis of the holder's interest in the entity.

Foreign corporations

Stock of a foreign corporation generally would not be an indexed asset. Thus, investors would not be permitted to place nonindexed assets in a foreign corporation (which generally is not subject to United States tax) and, in effect, receive an inflation adjustment for those assets by selling their stock in the foreign corporation at a later date. However, an exception would be made in the case of stock of a foreign corporation traded on an established domestic securities market, on the grounds that there would be little potential for the shareholders to transfer nonindexed assets to such a foreign corporation to obtain the adjustment. This exception would not apply to certain foreign corporations that are controlled by U.S. investors, or that hold substantial amounts of passive assets, or earn substantial amounts of passive income. An American Depository Receipt (ADR) for stock in a foreign corporation would be treated as stock in the foreign corporation and, therefore, the basis in an ADR would be indexed.

Other rules

Short sales

In the case of a short sale of an indexed asset with a short sale period in excess of one year, the bill would provide that the amount realized would be indexed for inflation in the same manner that the basis would be indexed to the holder of the property. If the taxpayer (or taxpayer's spouse) sells short substantially identical property to an asset held by the taxpayer (i.e., sells short "against the box") no indexing adjustments would be allowed during the short sale period.

Limitation on ordinary losses

The bill generally would not apply to assets that give rise to ordinary income or loss because they are not capital assets or trade or business property to the taxpayer. In addition, in the case of capital assets or trade or business property the sale of which could result in an ordinary loss (under sec. 1231), the provision would not be applied to create or increase the amount of ordinary loss. Instead, the amount of ordinary loss determined under that provision would be limited to the loss that would arise without regard to any inflation adjustment. Any additional loss created by the inflation adjustment would be treated as a long-term capital loss notwithstanding any existing provisions of the Code.

Related parties

The bill would not index the basis of property for sales or dispositions between related persons, except to the extent the basis of

⁶ Similar rules would apply to common trust funds.

property in the hands of the transferee is a substitute basis (e.g., gifts).

Collapsible corporations

Under the bill, indexing would not reduce the amount of ordinary gain that would be recognized in cases where a corporation is treated as a collapsible corporation (under sec. 341) with respect to a distribution or sale of stock.

Effective Date

The provisions would apply to dispositions of property after December 31, 1994, in taxable years ending after that date.

3. Capital loss deduction allowed with respect to sale or exchange of a principal residence (sec. 1003 of the bill and sec. 165 of the Code)

Present Law

Taxpayers generally may claim as a deduction any loss sustained during the taxable year and not compensated by insurance or otherwise. In the case of an individual, however, the deduction is limited to (1) losses incurred in a trade or business, (2) losses incurred in any transaction entered into for profit though not connected with a trade or business, and (3) catastrophic losses of property that arise from fire, storm, shipwreck, or other casualty or from theft. Deductions for losses from the sale or exchange of capital assets are subject to the limitations described above. In addition, taxpayers other than corporations may deduct capital losses against up to \$3,000 of ordinary income each year.

A loss on the sale or exchange of a principal residence is treated as a nondeductible personal loss. Gain on the sale or exchange of a principal residence generally is includible in gross income and is subject to a maximum rate of 28 percent. If an individual purchases a new principal residence within two years of selling the old residence, gain from the sale of the old residence (if any) is recognized only to the extent that the taxpayer's adjusted sales price exceeds the taxpayer's cost of purchasing the new residence (sec. 1034). A taxpayer also may elect to exclude from gross income up to \$125,000 of gain from the sale of a principal residence if the taxpayer (1) has attained age 55 before the sale and (2) has used the residence as a principal residence for three or more years of the five years preceding the sale of the residence (sec. 121). This election may be made only once.

Description of Proposal

The bill would provide that losses from the sale or exchange of a principal residence would be treated as a deductible capital loss rather than a nondeductible personal loss.

Effective Date

The provision would be effective for sales and exchanges after December 31, 1994, in taxable years ending after such date.

B. Neutral Cost Recovery (Title II of the bill and secs. 56 and 168 of the Code)

Present Law

Depreciation deductions

Under present law, a taxpayer is allowed depreciation deductions for the cost of property used in a trade or business. In general, depreciation for tangible property placed in service after 1986 is determined under the modified Accelerated Cost Recovery System (MACRS) enacted as part of the Tax Reform Act of 1986. MACRS includes a general depreciation system and an alternative depreciation system.

Under the general MACRS rules, depreciable property is divided into nine classes based on recovery periods (3-year property, 5-year property, 7-year property, 10-year property, 15-year property, 20-year property, 27.5-year residential rental property, 39-year nonresidential real property and 50-year railroad grading or tunnel bores). The 200-percent declining balance method of depreciation is used for 3-year, 5-year, 7-year, and 10-year property; the 150-percent declining balance method is used for 15-year and 20-year property and property used in a farming business; and the straight-line method is used for other property (including real property).

In general, the value of MACRS deductions are reduced under the alternative depreciation system by calculating depreciation using the straight-line method over the property's class life.⁷ A property's class life generally corresponds to its Asset Depreciation Range (ADR) midpoint life and often is longer than the recovery period applicable to the general MACRS. (The class lives and recovery periods of some assets are set by statute, regardless of the asset's ADR midpoint life.) The alternative depreciation system applies to foreign use property, tax-exempt use property, tax-exempt bond financed property, certain imported property, and property to which the taxpayer so elects and is used to compute corporate earnings and profits. The class lives of the alternative depreciation system are used for purposes of the corporate and individual alternative minimum tax. The alternative minimum tax generally applies the 150-percent declining balance method to tangible personal property placed in service after 1993.

Expensing election

In lieu of depreciation, a taxpayer may elect to expense and deduct up to \$17,500 of the cost of qualifying property placed in service for the taxable year.⁸ For this purpose, qualifying property generally is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The \$17,500 amount is reduced by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$200,000. In addition, the amount eligible to be expensed for a taxable year may not exceed the taxable income of the taxpayer

⁷ Annual depreciation deductions for passenger automobiles are also limited under section 280F.

⁸ The \$17,500 amount is increased to \$37,500 for certain property placed in service by an enterprise zone business.

for the year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations).

Description of Proposal

For MACRS property placed in service after December 31, 1994, the bill would allow a taxpayer to elect, on a property-by-property basis, to determine depreciation deductions under present law or under a new neutral cost recovery system (NCRS). The following describes the treatment of property under NCRS.

First, NCRS generally would follow MACRS but would replace the 200-percent declining balance method of MACRS with the 150-percent declining balance method.

In addition, depreciation for any taxable year after the year in which the property is placed in service would be determined by multiplying the deduction allowable for the property for the taxable year (determined without regard to this provision) by the "applicable neutral cost recovery ratio" for the year.

In the case of property that would otherwise qualify for the 200-percent declining balance method (but for the election to use NCRS), the applicable neutral cost recovery ratio for the year is first determined by dividing (1) the gross domestic product deflator for the calendar quarter ending in such taxable year which corresponds to the calendar quarter during which the property was placed in service by the taxpayer by (2) the gross domestic product deflator for the calendar quarter during which the property was placed in service by the taxpayer. This ratio is then multiplied by the number equal to 1.035 to the n th power, where " n " is the number of full years in the period beginning on the first day of the calendar quarter during which the property was placed in service and ending on the day before the beginning of the corresponding calendar quarter ending during the taxable year. In the case of other MACRS property (e.g., longer-lived property and property to which the alternative depreciation system applies), the applicable neutral cost recovery ratio for the year is determined by dividing (1) the gross domestic product deflator for the calendar quarter ending in such taxable year which corresponds to the calendar quarter during which the property was placed in service by the taxpayer by (2) the gross domestic product deflator for the calendar quarter during which the property was placed in service by the taxpayer. For any property, the applicable neutral cost recovery ratio may not be less than 1 and is rounded to the nearest one-thousandth.

The applicable neutral cost recovery ratio is also applied for purposes of determining depreciation under the alternative minimum tax (including the adjusted current earnings adjustment of the corporate alternative minimum tax).

The application of the applicable neutral cost recovery ratio generally would not be taken into account for purposes of (1) determin-

ing the adjusted basis of depreciable property⁹ or any interest in a pass-thru entity (as defined in proposed sec. 1201(d)(2)); (2) determining earnings and profits; or (3) the recapture provisions of sections 1245 and 1250.

NCRS would not apply to any property for which the taxpayer so elects¹⁰ or to property placed in service pursuant to certain churning transactions.

Effective Date

The provision would be effective for qualifying property placed in service after December 31, 1994.

⁹ The additional deductions allowed by the provision would increase the "unrecovered basis" of a passenger automobile to the extent such deductions are not allowed by reason of section 280F.

¹⁰ Any election, once made, would be irrevocable.

C. Public Debt Reduction Checkoff and Trust Fund (Title XI of the bill and new secs. 6097 and 9512 of the Code)

Present Law

The Presidential Election Campaign Fund ("Campaign Fund") provides for public financing of a portion of qualified Presidential election campaign expenditures and certain convention costs (sec. 9001 et seq.). The Campaign Fund is financed through the voluntary designation by individual taxpayers on their Federal income tax returns of \$3 of tax liability, which is commonly known as the Presidential election campaign checkoff (sec. 6096). This checkoff can be made only by individuals (not corporations) and does not affect the individual's tax liability.¹¹ The Treasury Department accumulates revenues in the Campaign Fund over a four-year period and then disburses funds to eligible candidates for President, Vice President, and conventions during the Presidential election year.¹²

Individuals who itemize deductions (as well as corporations) are allowed a deduction, subject to certain limitations, for contributions made to qualified charitable organizations or to Federal, State, and local governments. Instructions to IRS income tax forms inform taxpayers that they may make a gift to the Federal Government to reduce the public debt by enclosing with their return a separate check made payable to the "Bureau of Public Debt." In addition, various public laws provide that contributions to specific Federal entities or programs are regarded as gifts to the United States. Such contributions to the Bureau of Public Debt and to specific Federal entities or programs are deductible if the donor itemizes deductions for the year in which the contribution is made.

Description of Proposal

Individual taxpayers would be allowed to designate an amount up to 10 percent of their Federal income tax liability for a taxable year to be earmarked to reduce the Federal public debt. Such a designation could be made only at the time the taxpayer files his or her income tax return for a particular taxable year. An individual's decision whether or not to make a designation under the provision would not affect his or her tax liability. If an individual has no Federal income tax liability for a taxable year—i.e., the individual owes no Federal income tax after claiming allowable credits (other than the EITC) and any designation to the Presidential Election Campaign Fund—then such individual would not be allowed to make a designation to reduce the Federal debt on his or her return for that year.

¹¹ Prior to enactment of the Omnibus Budget Reconciliation Act of 1993 (OBRA 1993), individuals could designate \$1 of their Federal income tax liability to the Campaign Fund. For calendar year 1992, 20.5 million returns, or 18 percent of the total number of individual income tax returns, designated a total of \$29.6 million in contributions to the Campaign Fund. See Statement of Maurice B. Foley, Deputy Tax Legislative Counsel (Tax Legislation), Department of the Treasury, before the Ways and Means Subcommittee on Select Revenue Measures, U.S. House of Representatives, November 16, 1993.

¹² A number of States provide checkoffs on their income tax forms to permit taxpayers to fund State electoral campaigns, private charitable organizations, and State governmental programs. Some of the State programs require taxpayers to pay additional amounts to exercise the checkoff option, generally by accepting a smaller refund.

Under the bill, amounts earmarked by taxpayers to reduce the public debt would be transferred into a Public Debt Reduction Trust Fund ("Trust Fund"), which would be used only to retire or purchase Federal securities. The bill further would require that, on October 1st of each year, the Treasury Department provide Congress with an estimate of the total amount of earmarked funds designated by taxpayers for debt reduction on their returns for the last taxable year ending one year before the beginning of the current session of Congress. Congress would then have the option of enacting specific spending cuts in Federal programs to match the amounts designated for debt reduction or, otherwise, an across-the-board sequestration would be triggered in Federal spending for the fiscal year. Social security payments, net interest payments on Federal debt, and funding for certain insurance funds (e.g., the Resolution Trust Corporation, Federal Deposit Insurance Corporation, Bank Insurance Fund, National Credit Union Administration) would be exempt from sequestration under the proposal.

Effective Date

The provision would be effective for taxable years ending after the date of enactment, and would remain in effect until the entire outstanding Federal public debt is retired.

D. Small Business Incentives (Title XII)

1. Increase in unified estate and gift tax credits (sec. 12001 of the bill and secs. 2001(c), 2010, 2102(c)(3), 2505(a) and 6018(a) of the Code)

Present Law

Application of the estate and gift tax

A gift tax is imposed on lifetime transfers and an estate tax is imposed on transfers at death. Since 1976, the gift tax and the estate tax have been unified so that a single graduated rate schedule applies to cumulative taxable transfers made by a taxpayer during his or her lifetime and at death.¹³ Under this rate schedule, the unified estate and gift tax rates begin at 18 percent on the first \$10,000 in cumulative taxable transfers and reach 55 percent on cumulative taxable transfers over \$3 million.

The amount of gift tax payable for any calendar year generally is determined by multiplying the applicable tax rate (from the unified rate schedule) by the cumulative lifetime taxable transfers made by the taxpayer and then subtracting any gift taxes payable for prior taxable periods. This amount is reduced by any available unified credit (and other applicable credits) to determine the gift tax liability for the taxable period.

The amount of estate tax payable generally is determined by multiplying the applicable tax rate (from the unified rate schedule) by the cumulative post-1976 taxable transfers made by the taxpayer and then subtracting any gift taxes payable for prior calendar years (after 1976). This amount is reduced by any available unified credit (and other applicable credits) to determine the estate tax liability.

Unified credit

A unified credit is available with respect to taxable transfers by gift and at death. Since 1987, the unified credit amount has been fixed at \$192,800, which effectively exempts a total of \$600,000 in cumulative taxable transfers from the estate and gift tax. The benefits of the unified credit (and the graduated estate and gift tax rates) are phased out by a 5-percent surtax imposed upon cumulative taxable transfers over \$10 million and not exceeding \$21,040,000.¹⁴

The unified credit was originally enacted in the Tax Reform Act of 1976. As enacted, the credit was phased in over five years to a level that effectively exempted \$175,625 of taxable transfers from the estate and gift tax in 1981 (i.e., a unified credit of \$47,000). The Economic Recovery Tax Act of 1981 increased the amount of the unified credit each year between 1982 and 1987, from an effective exemption of \$225,000 in 1982 to an effective exemption of \$600,000 in 1987. The unified credit has not been increased since 1987.

¹³ Prior to 1976, separate tax rate schedules applied to the gift tax and the estate tax.

¹⁴ Thus, if a taxpayer has made cumulative taxable transfers exceeding \$21,040,000, his or her effective transfer tax rate will be 55 percent under present law.

Description of Proposal

The bill would gradually increase the present-law unified credit of \$192,800 to \$248,300 over a three-year period beginning in 1996. For decedents dying and gifts made in 1996, the unified credit would be \$229,800 (i.e., the amount that would effectively exempt \$700,000 in taxable transfers from the estate and gift tax). For decedents dying and gifts made in 1997, the unified credit would be \$239,050 (i.e., the amount that would effectively exempt \$725,000 in taxable transfers from the estate and gift tax). For decedents dying and gifts made after 1997, the unified credit would be \$248,300 (i.e., the amount that would effectively exempt \$750,000 in taxable transfers from the estate and gift tax).¹⁵ After 1998, the unified credit would be indexed for inflation each year by multiplying the applicable exclusion amount of \$750,000 by a cost of living adjustment.

Conforming amendments to reflect the increased unified credit would be made (1) to the 5-percent surtax in order to permit the proper phase out of the increased unified credit, (2) to the general filing requirements for an estate tax return under section 6018(a), and (3) to the amount of the unified credit allowed under section 2102(c)(3) with respect to nonresident aliens with U.S. situs property who are residents of certain treaty countries.

Effective Date

The provision would apply to the estates of decedents dying, and gifts made, after December 31, 1995.

2. Increase in expensing treatment for small businesses (sec. 12002 of the bill and sec. 179 of the Code)

Present Law

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to \$17,500 of the cost of qualifying property placed in service for the taxable year (sec. 179).¹⁶ In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The \$17,500 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$200,000. In addition, the amount eligible to be expensed for a taxable year may not exceed the taxable income of the taxpayer for the year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations).

¹⁵ Because the proposal effectively would exempt \$750,000 in cumulative taxable transfers after 1997, the lowest tax rate at which a tax liability would be incurred under the estate and gift tax after 1997 is 39 percent (as opposed to 37 percent under present law).

¹⁶ The \$17,500 amount is increased up to \$37,500 for certain property placed in service by a business located in an enterprise zone (sec. 1397A).

Description of Proposal

The bill would increase the \$17,500 amount allowed to be expensed under Code section 179 to \$25,000.

Effective Date

The provision would be effective for property placed in service in taxable years beginning after December 31, 1995.

3. Clarification of definition of principal place of business; Treatment of storage of product samples (secs. 12003 and 12004 of the bill and sec. 280A of the Code)

Present Law

A taxpayer's business use of his or her home may give rise to a deduction for the business portion of expenses related to operating the home (e.g., a portion of rent or depreciation and repairs). Code section 280A(c)(1) provides, however, that business deductions generally are allowed only with respect to a portion of a home that is used exclusively and regularly in one of the following ways: (1) as the principal place of business for a trade or business; (2) as a place of business used to meet with patients, clients, or customers in the normal course of the taxpayer's trade or business; or (3) in connection with the taxpayer's trade or business, if the portion so used constitutes a separate structure not attached to the dwelling unit. In the case of an employee, the Code further requires that the business use of the home must be for the convenience of the employer (sec. 280A(c)(1)). These rules apply to houses, apartments, condominiums, mobile homes, boats, and other similar property (sec. 280A(f)(1)).

Prior to 1976, expenses attributable to the business use of a residence were deductible whenever they were "appropriate and helpful" to the taxpayer's business. In 1976, Congress adopted section 280A, in order to provide a narrower scope for the home office deduction, but did not define the term "principal place of business." In *Commissioner v. Soliman*, 113 S.Ct. 701 (1993), the Supreme Court reversed lower court rulings and upheld an Internal Revenue Service (IRS) interpretation of section 280A that disallowed a home office deduction for a self-employed anesthesiologist who practiced at several hospitals but was not provided office space at the hospitals. Although the anesthesiologist used a room in his home exclusively to perform administrative and management activities for his profession (i.e., he spent two or three hours a day in his home office on bookkeeping, correspondence, reading medical journals, and communicating with surgeons, patients, and insurance companies), the Supreme Court upheld the IRS position that the "principal place of business" for the taxpayer was not the home office but, rather, was at the hospitals where he performed the "essence of the professional service."¹⁷ Because the taxpayer did not meet

¹⁷ In response to the Supreme Court's decision in *Soliman*, the IRS revised its Publication 587, *Business Use of Your Home*, to more closely follow the comparative analysis used in *Soliman* by focusing on the following two primary factors in determining whether a home office is a taxpayer's principal place of business: (1) the relative importance of the activities performed at each business location; and (2) the amount of time spent at each location.

with patients at his home office and the room was not a separate structure, a deduction was not available under the second or third exception under section 280A(c)(1) (described above).

Section 280A(c)(2) contains a special rule that allows a home office deduction for business expenses related to a space within a home that is used on a regular (even if not exclusive) basis as a storage unit for the inventory of the taxpayer's trade or business of selling products at retail or wholesale, but only if the home is the sole fixed location of such trade or business.

Description of Proposal

The bill would amend present-law section 280A to specifically provide that a home office qualifies as the "principal place of business" if (1) the office is the location where the taxpayer's essential administrative or management activities are conducted on a regular and systematic (and not incidental) basis by the taxpayer, and (2) the office is necessary because the taxpayer has no other location for the performance of the administrative or management activities of the business. As under present law, deductions would be allowed for a home office meeting the above two-part test only if the office is used exclusively as a place of business by the taxpayer, and in the case of an employee, only if such exclusive use is for the convenience of the employer.

In addition, the bill would clarify that the special rule contained in present-law section 280A(c)(2) permits deductions for expenses related to a storage area in a taxpayer's home regularly used for inventory or product samples (or both) of the taxpayer's trade or business of selling products at retail or wholesale, provided that the home is the sole fixed location of such trade or business.

As under present law, home office expenses deductions may not be claimed if they create (or increase) a net loss from a business activity, although such deductions may be carried over to subsequent taxable years (sec. 280A(c)(5)).

Effective Date

The provision would apply to taxable years beginning after 1995.

III. SENIOR CITIZENS' EQUITY ACT (H.R. 8)

A. Repeal of Increase in Tax on Social Security Benefits (sec. 201 of the bill and secs. 86 and 871(a)(3) of the Code)

Present Law

In general

Under present law, taxpayers receiving Social Security and Railroad Retirement Tier 1 benefits are not required to include any such benefits in gross income if their "provisional income" does not exceed \$25,000 in the case of unmarried taxpayers or \$32,000 in the case of married taxpayers filing joint returns. For purposes of these computations, a taxpayer's provisional income is defined as adjusted gross income plus tax-exempt interest plus certain foreign source income plus one-half of the taxpayer's Social Security or Railroad Retirement Tier 1 benefit.

Certain taxpayers with provisional income in excess of those thresholds are required to include in gross income up to 50 percent of their Social Security or Railroad Retirement Tier 1 benefit. Under a provision added by the Omnibus Budget Reconciliation Act of 1993, taxpayers with provisional income in excess of a second-tier threshold (\$34,000 in the case of unmarried taxpayers or \$44,000 in the case of married taxpayers filing joint returns) are required to include in gross income up to 85 percent of their Social Security or Railroad Retirement Tier 1 benefit.

If the taxpayer's provisional income exceeds the lower threshold but does not exceed the second-tier threshold, then the amount of the inclusion is the lesser of (1) 50 percent of the taxpayer's Social Security or Railroad Retirement Tier 1 benefit, or (2) 50 percent of the excess of the taxpayer's provisional income over the lower threshold.

If the amount of provisional income exceeds the second-tier threshold, then the amount of the inclusion is the lesser of:

(1) 85 percent of the taxpayer's Social Security or Railroad Retirement Tier 1 benefit, or

(2) the sum of:

(a) 85 percent of the excess of the taxpayer's provisional income over the second-tier threshold, plus,

(b) the smaller of (i) the amount of benefits that would have been included if the 50-percent inclusion rule (the rule in the previous paragraph) were applied, or (ii) one-half of the difference between the taxpayer's second-tier threshold and lower threshold.

Treatment of nonresident alien individuals

If a nonresident alien individual is engaged in a trade or business within the United States during the taxable year, the individ-

ual is subject to U.S. tax at the normal graduated rates on net taxable income that is effectively connected with the conduct of the U.S. trade or business. U.S. source fixed or determinable annual or periodic income of a nonresident alien individual (for example, salary, wages, annuities, compensation, remuneration, and emoluments) that is not effectively connected with the conduct of a U.S. trade or business generally is subject to tax at a rate of 30 percent of the gross amount paid. This latter tax generally is collected by means of withholding (hence this tax is often called a "withholding tax"). Withholding taxes are often reduced or eliminated in the case of payments to residents of countries with which the United States has an income tax treaty.

For purposes of taxing the income of nonresident alien individuals, the income thresholds for including Social Security and Railroad Retirement Tier 1 benefits do not apply. Instead, a fixed percentage of any such benefit is included in gross income. Until January 1, 1995, that percentage was 50 percent. Thus, prior to 1995, a nonresident alien individual typically was subject to U.S. withholding tax at an effective rate of 15 percent on the gross amount of U.S. Social Security benefits. This tax was reduced or eliminated under some treaties. Although the Omnibus Budget Reconciliation Act of 1993 increased the inclusion of benefits in some cases for taxpayers other than nonresident aliens (to up to 85 percent of the benefits), it did not amend the rule that a nonresident alien individual was required to include 50 percent (and only 50 percent) of these benefits in gross income.

The implementing legislation for the General Agreement on Tariffs and Trade (P.L. 103-465) increased from 50 percent to 85 percent the amount of Social Security or Railroad Retirement Tier 1 benefits included in the gross income of a nonresident alien individual, effective for benefits paid after December 31, 1994, in taxable years ending after such date. Thus, a nonresident alien individual may be subject to U.S. withholding tax at an effective rate of 25.5 percent on the gross amount of U.S. Social Security or Railroad Retirement Tier 1 benefits.

Description of Proposal

In general

The bill would phase in a repeal of the higher rate of income inclusion for taxpayers with provisional incomes in excess of the second-tier threshold.

For taxable years beginning in calendar years 1996 through 1999, if the amount of provisional income exceeds the second-tier threshold, then the amount of the inclusion would be calculated as under present law, except that the following rates would be substituted for "85 percent":

For taxable years beginning in calendar year	The percentage would be—
1996	75
1997	65
1998	60
1999	55

For taxable years beginning after December 31, 1999, Social Security and Railroad Retirement Tier 1 benefits would be treated as under the law prior to 1994: if the amount of provisional income exceeds \$25,000 in the case of unmarried taxpayers or \$32,000 in the case of married taxpayers filing joint returns, then the amount of the inclusion would be the lesser of (1) 50 percent of the taxpayer's Social Security or Railroad Retirement Tier 1 benefit, or (2) 50 percent of the excess of the taxpayer's provisional income over the threshold.

Treatment of nonresident alien individuals

The bill would phase in a reduction in the amount of Social Security or Railroad Retirement Tier 1 benefits included in the gross income of a nonresident alien individual. The inclusion percentage for any taxable year beginning in calendar years 1996 through 1999 would be as given in the table above. For taxable years beginning after December 31, 1999, the amount of Social Security or Railroad Retirement Tier 1 benefits included in the gross income of a nonresident alien individual would be 50 percent.

Effective Date

The provision would be effective for taxable years beginning after December 31, 1995.

B. Treatment of Long-Term Care (secs. 301-305, and 307 of the bill and secs. 104, 106, 213, 807(d), 1035, and 4980B and new secs. 137 and 818A of the Code)

Present Law

Deduction for medical expenses

In determining taxable income for Federal income tax purposes, a taxpayer is allowed an itemized deduction for unreimbursed expenses that are paid by the taxpayer during the taxable year for medical care of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer, to the extent that such expenses exceed 7.5 percent of the adjusted gross income of the taxpayer for such year (sec. 213). For this purpose, expenses paid for medical care generally are defined as amounts paid: (1) for the diagnosis, cure, mitigation, treatment, or prevention of disease (including prescription medicines or drugs and insulin), or for the purpose of affecting any structure or function of the body (other than cosmetic surgery not related to disease, deformity, or accident); (2) for transportation primarily for, and essential to, medical care referred to in (1); or (3) for insurance (including Part B Medicare premiums) covering medical care referred to in (1) and (2).

Exclusion for amounts received under accident or health insurance

Amounts received by a taxpayer under accident or health insurance for personal injuries or sickness generally are excluded from gross income to the extent that the amounts received are not attributable to medical expenses that were allowed as a deduction for a prior taxable year (sec. 104).

Treatment of accident or health plans maintained by employers

Contributions of an employer to an accident or health plan that provides compensation (through insurance or otherwise) to an employee for personal injuries or sickness of the employee, the employee's spouse, or a dependent of the employee, are excluded from the gross income of the employee (sec. 106). In addition, amounts received by an employee under such a plan generally are excluded from gross income to the extent that the amounts received are paid, directly or indirectly, to reimburse the employee for expenses incurred by the employer for the medical care of the employee, the employee's spouse, or a dependent of the employee (sec. 105). For this purpose, expenses incurred for medical care are defined in the same manner as under the rules regarding the deduction for medical expenses.

Health care continuation rules

The health care continuation rules require that an employer must provide qualified beneficiaries the opportunity to continue to participate for a specified period in the employer's health plan after the occurrence of certain events (such as termination of employment) that would have terminated such participation. Individuals

electing continuation coverage can be required to pay for such coverage.

Description of Proposals

In general

The bill would provide that long-term care insurance contracts that meet the requirements of the bill ("qualified long-term care insurance contracts") receive the tax treatment set forth in the bill. Other long-term care contracts would continue to be subject to present law.

Similarly, the bill would provide a safe harbor with respect to the deductibility of certain expenses for long-term care services. Expenses for services that satisfy the requirements of the bill would be deductible as medical expenses. Expenses for services that do not satisfy such requirements would continue to be subject to present law.

Qualified long-term care insurance

In order to receive the tax treatment set forth in the bill, a long-term care insurance contract would have to meet certain requirements (i.e., be a "qualified long-term care insurance contract"). Under the bill, a qualified long-term care insurance contract would be defined as any insurance contract that meets the following requirements: (1) the only insurance protection provided under such contract is coverage of qualified long-term care services (as defined under the bill) and benefits incidental to such coverage; (2) if Medicare is the primary payor, the contract does not cover expenses that are reimbursable under Medicare (or would be reimbursable but for the application of a deductible or coinsurance amount); (3) the contract is guaranteed renewable; (4) the contract does not have any cash surrender value; and (5) all refunds of premiums (other than refunds on surrender or cancellation of the contract), and all policyholder dividends or similar amounts under the contract are to be applied as a reduction in future premiums or to increase future benefits. Under the bill, a qualified long-term care contract could pay benefits either in the form of reimbursement for expenses or on a per diem or other periodic basis without regard to expenses.

Except as provided in Treasury regulations, in the case of long-term care insurance coverage provided by a rider on a life insurance contract, the requirements for a qualified long-term care insurance contract under the bill would apply as if the portion of the contract that provides long-term care insurance were a separate contract.

Definition of qualified long-term care services

The bill would define "qualified long-term care services" as necessary diagnostic, preventive, therapeutic, rehabilitative, and maintenance or personal care services, that (1) are required by a chronically ill individual in a qualified facility, and (2) are provided pursuant to a plan of care prescribed by a licensed health care practitioner. A "chronically ill individual" would mean any individual who has been certified by a licensed health care practitioner as (1)

being unable to perform (without substantial assistance) at least two activities of daily living (ADLs) for a period of at least 90 days due to a loss of functional capacity, (2) having a level of disability (as determined by the Secretary of the Treasury in consultation with the Secretary of Health and Human Services) similar to the level of disability described in (1), or (3) having a similar level of disability due to cognitive impairment.

The ADLs would be defined as mobility, dressing, toileting and bathing, transferring, and eating. A "qualified facility" would be defined as a nursing, rehabilitative, hospice, or adult day care facility (including a hospital, retirement home, nursing home, skilled nursing facility, intermediate care facility or similar institution) that is licensed under State law or that is a certified facility for purposes of Medicare or Medicaid. The home of a chronically ill individual would be a qualified facility if a licensed health care practitioner certifies that, without home care, the individual would have to be cared for in a qualified facility described in the previous sentence.

A licensed health care practitioner would be defined as any physician (as defined in sec. 1861(r) of the Social Security Act) and any registered professional nurse, licensed social worker, or other individual who meets such requirements as may be prescribed by the Secretary of the Treasury.

Insurance company taxation

The bill would generally provide that, for purposes of the Internal Revenue Code rules relating to taxation of insurance companies, a qualified long-term care insurance contract would be treated as accident or health insurance. In determining reserves for insurance company taxation purposes, the reserve method for qualified long-term insurance contracts would be a 1-year full preliminary term method.

Continuation coverage

The bill would provide that the health care continuation rules do not apply to coverage under a qualified long-term care insurance contract.

Exclusion for benefits provided under long-term care insurance; exclusion for employer-provided coverage

The bill would provide that benefits paid under a qualified long-term care insurance contract are excludable from gross income to the extent the benefits do not exceed \$200 per day (indexed for inflation after 1995). The \$200 limit is applied separately to each qualified long-term care contract. In addition, employer contributions for qualified long-term care insurance would be excludable from gross income. In applying the bill's \$200 limit on daily coverage under a qualified long-term care insurance contract for purposes of this exclusion, all contracts provided to the employee by the same employer would be aggregated. The bill would not permit qualified long-term care coverage to be provided through a cafeteria plan.

Long-term care services treated as medical care

The bill would provide that expenses for qualified long-term care services are treated as expenses for medical care for purposes of the itemized deduction for medical expenses. Thus, under the bill, a taxpayer would be allowed an itemized deduction for unreimbursed expenses that are paid by the taxpayer during any taxable year for qualified long-term care services that are provided to the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer, to the extent that such expenses and other eligible medical expenses of the taxpayer exceed 7.5 percent of adjusted gross income.

In addition, under the bill, eligible medical expenses for purposes of the medical expense deduction would, within certain limits, include premiums paid for qualified long-term care insurance. Eligible long-term care premiums would be premiums for qualified long-term care insurance that do not exceed the following amounts:

In the case of an individual with an attained age before the close of the taxable year of	The limitation is
Not more than 40	\$200
More than 40 but not more than 50	375
More than 50 but not more than 60	750
More than 60 but not more than 70	2,000
More than 70	2,500

Beginning after 1995, these dollar limits would be indexed for increases in the medical care cost component of the consumer price index.

Exchanges of life insurance contracts for long-term care insurance contracts

The bill would provide that the exchange of a life insurance contract for a qualified long-term care insurance contract is not taxable.

Exclusion from income for amounts withdrawn from IRAs and section 401(k) plans for long-term care insurance

The bill would provide that distributions from individual retirement arrangements (IRAs) and qualified cash or deferred arrangements (sec. 401(k) plans) are excludable from gross income to the extent used to pay premiums on a qualified long-term care insurance contract. In the case of distributions from a section 401(k) plan, such tax treatment would apply only to distributions of elective deferrals. A section 401(k) plan would not fail to be a qualified cash or deferred arrangement merely because it permits distributions which are excludable from income under the bill.

Treasury report

The bill would direct the Secretary of the Treasury to submit to the Congress no later than October 1, 1995, a report detailing the Treasury's interpretation of the treatment of long-term care insurance contracts that are not qualified long-term care contracts.

Effective Date

The provisions generally would be effective for taxable years beginning after December 31, 1995.

Any policy issued before January 1, 1996, which met the requirements for long-term care insurance of the State in which the policy was situated at the time the policy was issued would be treated as a qualified long-term care insurance contract, and services provided under such a policy would be treated as qualified long-term care services.

Long-term care insurance contracts could be exchanged tax free for qualified long-term care insurance contracts between the date of enactment and January 1, 1996. The cancellation of a policy and reinvestment of the cancellation proceeds in a qualified long-term care insurance contract within 60 days would be treated as an exchange. Taxable gain would be recognized to the extent money and property other than a qualified long-term care insurance contract is received in the exchange.

The issuance of a rider on a life insurance contract providing long-term care insurance coverage would not be treated as a modification or material change of such contract for purposes of determining whether Code section 7702 (relating to the definition of life insurance contract) or section 7702A (relating to the definition of modified endowment contract) applies.

C. Tax Treatment of Accelerated Death Benefits under Life Insurance Contracts (sec. 306 of the bill and sec. 101 of the Code)

Present Law

Treatment of amounts received under a life insurance contract

If a contract meets the definition of a life insurance contract, gross income does not include insurance proceeds that are paid pursuant to the contract by reason of the death of the insured (sec. 101(a)). In addition, the undistributed investment income ("inside buildup") earned on premiums credited under the contract is not subject to current taxation to the owner of the contract. The exclusion under section 101 applies regardless of whether the death benefits are paid as a lump sum or otherwise.

Amounts received under a life insurance contract (other than a modified endowment contract) prior to the death of the insured are includible in the gross income of the recipient to the extent that the amount received exceeds the taxpayer's investment in the contract (generally, the aggregate amount of premiums paid less amounts previously received that were excluded from gross income).

If a contract fails to be treated as a life insurance contract under section 7702(a), inside buildup on the contract is generally subject to tax.

Requirements for a life insurance contract

To qualify as a life insurance contract for Federal income tax purposes, a contract must be a life insurance contract under the applicable State or foreign law and must satisfy either of two alternative tests: (1) a cash value accumulation test or (2) a test consisting of a guideline premium requirement and a cash value corridor requirement (sec. 7702(a)). A contract satisfies the cash value accumulation test if the cash surrender value of the contract may not at any time exceed the net single premium that would have to be paid at such time to fund future benefits under the contract. A contract satisfies the guideline premium and cash value corridor tests if the premiums paid under the contract do not at any time exceed the greater of the guideline single premium or the sum of the guideline level premiums, and if the death benefit under the contract is not less than a varying statutory percentage of the cash surrender value of the contract.

Proposed regulations on accelerated death benefits

The Treasury Department has issued proposed regulations under which certain "qualified accelerated death benefits" paid by reason of the terminal illness of an insured are treated as paid by reason of the death of the insured and therefore qualify for exclusion under section 101. In addition, the proposed regulations permit an insurance contract that includes a qualified accelerated death benefit rider to qualify as a life insurance contract under section 7702. Thus, the proposed regulations provide that including this benefit would not cause an insurance contract to fail to meet the definition of a life insurance contract.

Under the proposed regulations, a benefit qualifies as a qualified accelerated death benefit only if it meets three requirements. First, the accelerated death benefit can be payable only if the insured becomes terminally ill (as described below). Second, the amount of the benefit must equal or exceed the present value of the reduction in the death benefit otherwise payable.¹⁸ Third, the cash surrender value and the death benefit payable under the policy must be reduced proportionately as a result of the accelerated death benefit.

For purposes of the proposed regulations, an insured is treated as terminally ill if he or she has an illness that, despite appropriate medical care, the insurer reasonably expects to result in death within 12 months from the payment of the accelerated death benefit.

Description of Proposal

The bill would provide an exclusion from gross income for any amount paid or advanced to an individual under a life insurance contract if the insured under the contract is either (1) terminally ill or (2) chronically ill and confined to a qualified facility.

For this purpose, an individual would be considered terminally ill if a physician¹⁹ has certified that the individual has an illness or physical condition that reasonably can be expected to result in death within 12 months of the certification.

A "chronically ill individual" would mean any individual who has been certified by a licensed health care practitioner²⁰ as (1) being unable to perform (without substantial assistance) at least two activities of daily living for a period of at least 90 days due to a loss of functional capacity, (2) having a level of disability (as determined by the Department of the Treasury in consultation with the Department of Health and Human Services) similar to the level of disability described in (1), or (3) having a similar level of disability due to cognitive impairment. The activities of daily living would be defined as mobility, dressing, toileting and bathing, transferring, and eating.

A "qualified facility" would be defined as a nursing, rehabilitative, hospice, or adult day care facility (including a hospital, retirement home, nursing home, skilled nursing facility, intermediate care facility or similar institution) that is licensed under State law or that is a certified facility for purposes of Medicare or Medicaid. The home of a chronically ill individual would be a qualified facility if a licensed health care practitioner certifies that, without home care, the individual would have to be cared for in a qualified facility described in the previous sentence.

¹⁸ For purposes of determining the present value, the maximum permissible discount rate is the greater of (1) the applicable Federal rate that applies under the discounting rules for property and casualty insurance loss reserves, and (2) the interest rate applicable to policy loans under the contract. Also, the present value is determined assuming that the death benefit would have been paid 12 months after payment of the accelerated death benefit.

¹⁹ The term "physician" would have the same meaning as in sec. 1861(r) of the Social Security Act.

²⁰ A licensed health care practitioner would be defined as any physician (as defined in sec. 1861(r) of the Social Security Act) and any registered professional nurse, licensed social worker, or other individual who meets such requirements as may be prescribed by the Secretary of the Treasury.

Effective Date

The provision would apply to taxable years beginning after December 31, 1995.

IV. FAMILY REINFORCEMENT ACT (H.R. 11)

A. Refundable Credit for Adoption Expenses (sec. 101 of the bill and sec. 35 of the Code)

Present Law

Present law does not provide a tax credit for adoption expenses. The Federal Adoption Assistance program (a Federal outlay program) provides financial assistance for the adoption of certain special needs children. In general, a special needs child is defined as a child who (1) according to a State determination, could not or should not be returned to the home of the natural parents and (2) could not reasonably be expected to be adopted unless adoption assistance is provided, on account of a specific factor or condition (such as ethnic background, age, membership in a minority or sibling group, medical condition, or physical, mental or emotional handicap). Specifically, the program provides assistance for adoption expenses for those special needs children receiving Federally assisted adoption assistance payments as well as special needs children in private and State funded programs. The maximum Federal reimbursement is \$1,000 per special needs child. Reimbursable expenses include those associated directly with the adoption process such as legal costs, social service review, and transportation costs.

Description of Proposal

The bill would provide taxpayers with a maximum refundable tax credit of \$5,000 per child for qualified adoption expenses paid or incurred by the taxpayer. Qualified adoption expenses would be reasonable and necessary adoption fees, court costs, attorneys' fees and other expenses that are directly related to the legal adoption of a child. No credit would be allowed for expenses incurred in connection with the violation of State or Federal law, any surrogate parenting arrangement, or the adoption of a child of the taxpayer's spouse. The credit would be phased out ratably for taxpayers with adjusted gross income (AGI) above \$60,000 and would be fully phased out at \$100,000 of AGI.

To avoid a double benefit, the bill would deny the credit to taxpayers who may use otherwise qualified adoption expenses as the basis of another credit or deduction. Also, the credit would not be allowed for any expenses for which a grant is received under any Federal, State, or local program. The bill would provide that couples who are married at the end of the taxable year must file a joint return to receive the credit unless they lived apart for the last six months of the taxable year and the individual claiming the credit (1) maintained as his or her home a household for the child for more than one-half the taxable year and (2) furnished over one-half the cost of maintaining that household in that taxable year.

Finally, the bill would provide that an individual legally separated from his spouse under a decree of divorce or separate maintenance would not be considered married.

Effective Date

The provision would be effective for taxable years beginning after December 31, 1995.

B. Refundable Credit for Custodial Care of Certain Elderly Dependents in Taxpayer's Home (sec. 201 of the bill and new sec. 36 of the Code)

Present Law

Generally, present law does not provide for tax credits based solely on custodial care of parents or grandparents. However, taxpayers with dependent parents generally are able to claim a personal exemption for these dependents. The total amount of personal exemptions is subtracted (along with certain other items) from adjusted gross income (AGI) in arriving at taxable income. The amount of each personal exemption is \$2,500 for 1995, and is adjusted annually for inflation. The amount of the personal exemption is phased out for taxpayers with AGI in excess of \$114,700 for single taxpayers, \$143,350 for heads of households, and \$172,050 for married couples filing joint returns.

Description of Proposal

The bill would provide taxpayers who maintain a household including one or more "qualified persons" with a maximum refundable credit of \$500 for each qualified person.

To be a "qualified person," an individual would have to pass a relationship test, a residency test and a disability test. The individual would satisfy the relationship test if the individual is a (1) father, stepfather, mother or stepmother of either the taxpayer, the taxpayer's spouse or the taxpayer's former spouse, or (2) a father, stepfather, mother or stepmother of one of the people described in (1).

An individual would satisfy the residency test if the individual has the same principal place of abode as the taxpayer for more than half of the taxable year.

An individual would satisfy the disability test if the individual is certified by a physician as being unable to perform at least two activities of daily living without substantial assistance from another individual. A physician would include a doctor of medicine or osteopathy who is legally authorized to practice medicine or surgery in the jurisdiction where the certification takes place.

The activities of daily living would include bathing, dressing, toileting, transfer, and eating. Bathing would be the overall complex behavior of getting water and cleansing the whole body, including turning on the water for the bath, shower, or sponge bath, getting to, in, and out of a tub or shower, and washing and drying oneself. Dressing would be the overall complex behavior of getting clothes from closets and drawers and then getting dressed. Toileting would be the act of going to the toilet room for bowel or bladder function, transferring on and off the toilet, cleaning after elimination, and arranging clothes. Transfer would be the process of getting in or out of bed or in or out of a chair or wheelchair. Eating would be the process of getting food from a plate or its equivalent into the mouth.

The bill would provide that an individual would be treated as maintaining a household for any period only if over one-half the cost of maintaining a household for such period is furnished by

such individual or, if such individual is married, by such individual and his or her spouse. The bill would also provide that individuals who are married at the end of the taxable year must file a joint return to receive the credit unless they lived apart for the last six months of the taxable year and the individual claiming the credit (1) maintained as his or her home a household for the qualified person for more than one-half the taxable year and (2) furnished over one-half of the cost of maintaining that household in that taxable year. Finally, the bill would provide that an individual legally separated from his or her spouse under a decree of divorce or of separate maintenance would not be considered married for purposes of this provision.

Effective Date

The provision would be effective for taxable years beginning after December 31, 1995.

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