DESCRIPTION OF ADDITIONAL MISCELLANEOUS TAX PROPOSALS

Scheduled for a Hearing

Before the

SUBCOMMITTEE ON SELECT REVENUE MEASURES

of the

HOUSE COMMITTEE ON WAYS AND MEANS

on October 26, 1989

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of additional miscellaneous tax proposals scheduled for a hearing before the House Ways and Means Subcommittee on Select Revenue Measures on October 26, 1989.

The provisions scheduled for the hearing are issues raised by Members during the Committee's consideration of revenue reconciliation, and which were deferred pending Subcommittee hearing on the provisions.

A prior Subcommittee hearing was held on October 12, 1989, on certain miscellaneous tax issues.[2]

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[1] This document may be cited as follows: Joint Committee on Taxation, Description of Additional Miscellaneous Tax Proposals (JCX-66-89), October 20, 1989.

[2] See, Joint Committee on Taxation, Description of Miscellaneous Tax Proposals (JCX-62-89), October 6, 1989. Also, see JCX-64-89, October 11, 1989, for a discussion of an issue added to the hearing.

DESCRIPTION OF PROPOSALS

A. Tax-Exempt Bond Provisions

1. Limitations on certain hospital bonds

Present Law

Bonds which finance activities of nongovernmental persons are private activity bonds. Only certain private activity bonds, including qualified 501(c)(3) bonds are tax exempt.

While there is a $150 million per institution limit on qualified 501(c)(3) bonds for nonhospital use, there is no dollar volume limit on qualified 501(c)(3) bonds for hospital use. There is no direct requirement that institutions which utilize qualified 501(c)(3) bonds provide any indigent care.

Explanation of Proposal

The proposal would provide that unless a hospital provides a minimum level of care to indigents its bonds for both hospital and nonhospital uses would be subject to the $150 million per institution limit. Under the proposal, the $150 million limit would apply to any bonds issued within the three-year period ending when the hospital fails the indigent care requirement and any bonds outstanding as of the beginning of that three-year period. A hospital would satisfy the indigent care requirement if it has an average "disproportionate patient percentage" of at least 10 percent for the previous three years. The disproportionate patient percentage computation is currently used to determine reimbursements to hospitals under the Medicare program.

The proposal also would provide two alternatives to subjecting the hospital's bonds to the $150 million limit. Under the first alternative, the State in which the facility is located could elect to lower the State bond volume cap by the ratio that the hospital's average disproportionate patient percentage is less than 10 percent. Under the second alternative, the issuer of the 501(c)(3) bonds otherwise affected by this proposal could elect to pay a penalty to the Federal Government. The amount of the penalty must equal the difference between the rate of interest paid on the bonds grossed up by one minus the highest marginal tax rate and the rate of interest paid on the bonds.

Effective Date

The proposal would be effective for bonds issued after the date of enactment.

2. Residential rental housing bonds (H.R. 151)

Present Law

Interest on bonds to finance governmental activities of States and local governments is tax-exempt. Interest on private activity bonds is taxable unless a specific exception is provided in the Code.

The purchase of residential rental property by a governmental unit outside the jurisdiction of that governmental unit is treated as the purchase of investment property, and thereby subject to arbitrage limitations, if financed with the proceeds of tax-exempt bonds. An exception exists if the property is purchased pursuant to a Federal or State court-ordered housing desegregation plan.

One exception for private activity bonds permits tax-exempt financing for qualified residential rental projects owned by private, for-profit persons (sec. 142). Rental housing qualifying for tax-exempt financing under this exception must meet minimum low-income tenant occupancy requirements throughout the qualified project period (generally 15 years) after the bonds are issued and the housing is placed in service. These requirements are that either (1) at least 20 percent of the housing units in the project be occupied by tenants having incomes of 50 percent or less of area median income, or (2) at least 40 percent of the housing units in the project be occupied by tenants having incomes of 60 percent or less of area median income.

Another exception permits private activity bonds to be issued to finance exempt activities of section 501(c)(3) organizations. Qualified 501(c)(3) bonds may be used to finance residential rental housing when housing is an exempt purpose of the nonprofit organization owning and operating the housing. The low-income tenant requirements that apply to private, for-profit rental housing only apply to qualified 501(c)(3) bonds when the proceeds are used to finance the acquisition of existing property.

Explanation of Proposal

Qualified 501(c)(3) bonds

H.R. 151 generally would require that bonds issued by 501(c)(3) organizations to finance any rental housing, new or existing, meet the present-law income targeting tests of Code section 142(d) (the 20/50 or 40/60 tests). Bonds failing to meet this test would not be qualified 501(c)(3) bonds. To be a qualified 501(c)(3) bond, the housing must satisfy the income targeting requirements regardless of whether such property is available to members of the general public. The bill would clarify that continuing care facilities are housing, and subject to the restrictions. An exception is provided for property financed by the proceeds of bonds issued by a general purpose governmental unit if the bonds are primarily secured by the full faith and credit of the governmental unit.

Governmental bonds

The bill would subject any rental property financed with bonds issued by a governmental unit which is located within the jurisdiction of such governmental unit to the low-income targeting requirements unless the bonds are primarily secured by the full faith and credit of the issuer. Failure to satisfy the low-income targeting requirements would result in the property being classified as investment property, and the earnings subject to the arbitrage rebate requirements. Rental property provided pursuant to a court order or approved housing desegregation plan would be exempt.

Effective Date

The proposal would be generally effective for bonds issued after January 3, 1989. The proposal would exempt construction in progress or subject to a binding agreement. In addition, exception is provided for certain refunding bonds.

3. Exception to private loan and disproportionate use tests for subsidized housing loans

Present Law

The interest on bonds issued by State and local governments generally is tax-exempt. Bonds used to finance activities of nongovernmental persons are private activity bonds. Unlike financing for governmental purposes, the interest on private activity bonds is generally taxable unless specific exception is provided in the Code. Two tests are used to determine whether a bond is a private activity bond. A bond is a private activity bond if it satisfies either test.

The first test provides that a bond is a private activity bond if more than 10 percent of the proceeds are used for any private business use and more than 10 percent of the principal and interest payable is secured, directly or indirectly, by private security payments.

Under the second test 5 a bond is a private activity bond if the bond meets either the "private loan test" or the "disproportionate use test." Under the private loan test, a bond is a private activity bond if the amount of proceeds used to make or finance loans to persons other than governmental units exceeds the lesser of 5 percent of the proceeds of the issue or $5 million. Under the disproportionate use tests a bond is a private activity bond if more than 5 percent of the proceeds is used in a private use which is disproportionate or unrelated to the governmental use of the proceeds and if more than 5 percent of the principal or interest is secured by payments from such use (disproportionate or unrelated use test).

One exception for private activity bonds permits tax-exempt financing for qualified residential rental property owned by private, for-profit persons. Rental housing qualifying for tax-exempt financing under this exception must meet minimum low-income tenant occupancy requirements throughout a qualified project period (generally 15 years) after the bonds are issued and the housing is placed in service. These requirements are that either at least 20 percent of the housing units in the project be occupied by tenants having incomes of 50 percent or less of area median income, or at least 40 percent of the housing units in the project be occupied by tenants having incomes of 60 percent or less of area median income.

Another exception for private activity bonds permits tax-exempt financing for qualified mortgage bonds for first-time homebuyers. The price of owner occupied housing qualifying for tax-exempt financing under this exception must not exceed 90 percent of the area's mean house price. The income of a qualifying mortgage cannot exceed 100 percent of area median if the household consists of 1 or 2 persons, and cannot exceed 115 percent of area median if the household consists of 3 or more persons.

Explanation of Proposal

In general

The proposal would provide an exemption from the private loan test and disproportionate or unrelated use test for certain proceeds used to provide, construct, acquire, repair, or rehabilitate housing. To qualify for this exemption, (1) the proceeds of the bond issue must be secured by the full faith and credit of the issuer, and (2) loans made with the proceeds of the bond issue for housing must charge an interest rate no greater than one half of the rate the issuer is paying on the bonds.

The initial occupants of such housing must satisfy income targeting requirements. In addition, any loans made under the proposal would have to provide restrictions, enforceable against the property so financed, which would encourage continued low- and moderate-income use.

Income targeting requirements of initial occupants

The tenants or owners of the housing financed using these bonds must satisfy income targeting requirements. In the case of owner-occupied housing, the purchaser must meet present-law requirements qualified mortgage bonds. All tenants of new or substantially rehabilitated rental housing must, at the time of initial occupancy, have family incomes at or below area median income adjusted for family size. Any occupied existing housing using the proceeds of an issue under the proposed exception must be located in a census tract in which the median income is no greater than 80 percent of the area median income.

Provisions for long-term low- and moderate-income use

Owner-occupied housing.--In the case of an owner-occupied residence which was purchased with loans made from qualifying bond proceeds, the proposal would require that any subsequent sale satisfy one of two alternatives: (1) any subsequent owner during the 10-year period following the initial purchase must satisfy the income tests applicable to qualified mortgage bonds; and (2) on any sale which is made during the 15-year period[3] following the initial purchase, the interest rate subsidy would be recaptured upon

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[3] If the loan is repaid in less than 15 years, this alternative is deemed to be satisfied.

disposition to the extent there is any gain on the sale of the property.

Rental housing.--The rent on all assisted units would be restricted to a level set by the issuer at time of initial occupancy. Any increases in rent in subsequent years would be determined by the issuer, based upon increases in operating and maintenance costs in the jurisdiction. Subsequent vacant units could be rented only to tenants with incomes no more than four times the rent. For new or substantially rehabilitated rental housing, cooperative or condominium conversion would be barred for at least 15 years. For existing housing, cooperative or condominium conversion would be barred for the term of loan, unless the loan is repaid earlier.

Effective Date

The proposal would be effective for bonds issued after December 31, 1989.

4. Modify public approval requirements for certain 501(c)(3) bond pools

Present Law

Generally, the interest on private activity bonds is taxable. However, certain types of private activity bonds generate tax-exempt interest if specified conditions are fulfilled. Among these conditions is a requirement of public approval by the government unit issuing the bonds (or on whose behalf they are issued) and each government unit having jurisdiction over the area where any facility being financed by these bonds is to be located. Public approval requires either approval by an applicable elected representative after a public hearing, or a referendum of the voters of the government unit. Treasury Regulations require that a general functional description of the facility be furnished along with the specific location of the facility (e.g., the address) so that informed public approval may be given.

Explanation of Proposal

The proposal would provide an exception to the specific identification requirement contained in Treasury Regulations. The exception would be available in situations where (1) bonds are issued to finance more than one facility for a specified State or local government sponsored health plan (such as an AIDS treatment program); and (2) unforeseen circumstances (for instance, the inability to receive certificate of need approval) make it infeasible for an approved facility to be established. In this situation, another facility can be substituted for the original facility if:

(a) the substituted facility is part of the same health care or social service program;

(b) the bonds meet the temporary period exception from the arbitrage rebate rules; and

(c) there is at least one public hearing before the bond proceeds are expended on the substituted facility at which this facility is specifically identified.

Effective Date

The proposal would be effective on date of enactment.

5. Enhance Tennessee Valley Authority access to Federal Financing Bank

Present Law

The Federal Financing Bank (FFB) provides access to debt financing for a number of specified Federal agencies, including the Tennessee Valley Authority (TVA). The FFB provides financing by purchasing debt instruments from these selected agencies in accordance with lending policies adopted by its Board of Directors in 1975. One of these lending policies precludes borrowing agencies from also obtaining debt financing from other sources, such as public capital markets.

Explanation of Proposal

The proposal would amend the Federal Financing Bank Act of 1973 to permit TVA to issue debt directly to private lenders while still maintaining access to future debt financing through the FFB. TVA intends to use the debt issued to refinance outstanding debt that carries high interest rates. The FFB does not currently permit borrowing agencies to refinance outstanding debt.

Effective Date

This proposal would be effective on date of enactment.

B. Corporate Provisions

1. Modification to the definition of corporations subject to the accumulated earnings tax (H.R. 460)

Present Law

An accumulated earnings tax is imposed on corporations that are formed or availed of for the purpose of avoiding the income tax with respect to shareholders by permitting earnings and profits of the corporation to accumulate instead of being distributed. Where applicable, the tax is imposed at a rate of 28 percent on accumulated taxable income. The term "accumulated taxable income" means regular taxable income, with certain adjustments, reduced by a deduction for dividends paid and an accumulated earnings credit.

In 1984, Congress provided that the application of the accumulated earnings tax to a corporation was to be determined without regard to the number of shareholders of such corporation.

Explanation of Proposal

The proposal would repeal the provision which provides that the accumulated earnings tax is to be applied to a corporation without regard to the number of shareholders of such corporation.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1987.

2. Modify effect of deduction for worthless stock on ownership changes

Present Law

Under present law, a worthless stock deduction taken by a shareholder who owns 50-percent or more of the stock of the corporation (a "50-percent shareholder") may result in a limitation on the use of such corporation's losses. In particular, if any stock held by a 50-percent shareholder is treated by such shareholder as becoming worthless, and such stock is held by the shareholder at the end of the taxable year of the shareholder in which such stock is treated as becoming worthless, the ownership of such stock will be treated as having changed for purposes of determining whether an ownership change of the corporation has occurred (Code sec. 382(g)(4)(D)). If an ownership change occurs, the losses of the corporation will be subject to limitation.

Explanation of Proposal

The proposal would provide that, in cases in which a company emerges from bankruptcy and in which an ownership change occurred during the pendency of the bankruptcy as a result of the worthless stock deduction taken by a 50-percent shareholder, the company could redetermine whether an ownership change occurred by counting toward the ownership change only that amount of stock held by the 50-percent shareholder in the post-bankruptcy corporation. If, as a result of such redetermination, no ownership change occurred during the pendency of the bankruptcy proceeding, an amended return could be filed by the corporation for prior years in which losses were limited (without regard to the otherwise applicable statute of limitations).

In addition, the proposal would provide that a 50-percent shareholder must recapture any worthless stock deduction taken with respect to stock of the pre-bankruptcy corporation if such a shareholder receives any stock in the post-bankruptcy corporation.

Alternatively, the proposal described above could be modified so as to permit a redetermination of whether an ownership change had occurred only in cases where a 50-percent shareholder owns no stock in the post-bankruptcy corporation. Under such an approach, there would be no recapture of such a shareholder's worthless stock deduction.

Effective Date

The proposal would be effective with respect to worthless stock deductions claimed by a 50-percent shareholder in taxable years ending after the date of committee action.

3. Extension of corporate capital loss carryforward period

Present Law

A corporation generally may carry back a capital loss to each of the 3 taxable years preceding the loss year; any excess generally may be carried forward for 5 years following the loss year (sec. 1212). Any loss remaining after the 5-year carryforward period cannot be deducted.

For purposes of the alternative minimum tax, net operating losses and certain other items cannot be used to offset more than 90 percent of a corporation's pre-foreign tax credit tentative minimum tax which would otherwise be determined (sec. 56).

Explanation of Proposal

The carryover period for corporate capital losses would be extended from 5 years to 15 years, with certain phase-in limitations on the allowable usage after the fifth year. Specifically, a maximum of 5 percent of the losses that would expire in 1989 under present law could be used in 1992, 10 percent in 1993, and 15 percent in 1994. A maximum of 5 percent of the losses that would expire under present law in 1990 could be used in 1993 and 10 percent in 1994. A maximum of 5 percent of the losses that would expire under present law in 1991 could be used in 1994.

For purposes of the alternative minimum tax, corporate capital loss carryovers would be limited to 90 percent of the corporation's capital gain in the carryover year.

Effective Date

The proposal with respect to extension of the capital loss carryover period would be effective for taxable years ending after December 31, 1988. The proposal with respect to the alternative minimum tax would be effective for taxable years beginning after December 31, 1989.

4. Small business high technology provisions

Present Law

Treatment of start-up expenditures

A taxpayer is not allowed a current deduction for start-up expenditures but may elect to amortize such expenditures over a period of 60 months or more. The election must be made no later than the time of filing the return for the taxable year in which the trade or business begins, and the election period selected by the taxpayer must be used by the taxpayer in such taxable year and all subsequent periods.

Amortized research and experimental costs and start-up costs under the alternative minimum tax

At the election of the taxpayer, research and experimental expenditures may be deducted in the year paid or incurred (sec. 174(a)), or capitalized and amortized over a period of not less than 60 months (sec. 174(b)).

Under the corporate add-on minimum tax applicable for years beginning before January 1, 1987, the difference between the deduction allowable for expensing research and experimental expenditures and the amount that would have been allowed had such expenditures been amortized ratably over a 10-year period was an item of tax preference for personal holding companies. Start-up costs were not treated as an item of tax preference for purposes of the add-on tax.

Under the alternative minimum tax applicable for years beginning after December 31, 1986, research and experimental expenditures is not a preference for corporations. However, for taxable years beginning in 1987, 1988, and 1989, one half of the difference between the adjusted net book income of a corporation and its alternative minimum taxable income (determined without reference to this adjustment and the alternative tax net operating loss deduction) is a preference (known as the book income adjustment).

Thus, corporate taxpayers that had elected to amortize pre-1987 research and experimental expenditures and start-up costs, may be subject to the alternative minimum tax in 1987, 1988, or 1989 due to the book income adjustment (because alternative minimum taxable income would reflect such amortization while book income may not).

Net operating losses for research companies

A taxpayer may currently deduct research and experimental expenditures paid or incurred in connection with his trade or business. Alternatively, the taxpayer may elect to amortize research and experimental expenditures over a period of 60 months or more. The election period selected by the taxpayer must be used by the taxpayer in the year the election is made and in all following taxable years.

After an ownership change, the taxable income of a loss corporation available for offset by pre-acquisition net operating loss carryforwards and built-in losses is limited. In general, an ownership change occurs if the percentage of any one or more 5-percent shareholders (i.e., shareholders holding 5 percent or more of the stock before or after the ownership change) has increased by more than 50 percentage points at any time during the testing period (generally a three-year period).

Definition of personal holding company income

A 28-percent tax is imposed (in addition to other Federal income tax) on undistributed personal holding company income. Personal holding company income generally includes passive income such as interest, dividends, and certain rents and royalties.

Treatment of deferred pre-1987 alternative minimum tax

For years beginning before 1987, a corporation's payment of the add-on minimum tax was deferred to the extent the corporation's tax preferences increased a net operating loss carryforward. For taxable years beginning after 1986, net operating losses are reduced, for purposes of the alternative minimum tax, by the amount of any pre-1987 tax preference included in the net operating loss.

Explanation of Proposal

Treatment of start-up expenditures

Taxpayers would be required to amortize start-up expenditures over 60 months or more unless the taxpayer elects to capitalize and not amortize start-up expenditures.

Amortized research and experimental costs and start-up costs under the alternative minimum tax

For purposes of the book income adjustment of the alternative minimum tax, amortization deductions for research expenses and start-up expenses would be treated as an alternative minimum tax net operating loss deduction. Thus, such amortization deductions would be deductible in computing alternative minimum taxable income but would not give rise to the book income adjustment for taxable years beginning in 1987, 1988, and 1989.

Net operating losses for research companies

A new loss corporation having elected to currently deduct research and experimental expenditures would be allowed to retroactively change its election so that it may amortize research and experimental expenditures. These remaining unamortized expenses would not be treated as built-in losses. Also, for purposes of determining whether an ownership change has occurred, a taxpayer may elect to treat convertible preferred stock as if it had been converted to common stock on the change date. If an ownership change would have occurred in the absence of this provision, pre-change losses in excess of those attributable to research and experimental expense would be limited as if an ownership change had occurred.

Definition of personal holding company income

Personal holding company income would no longer include technological royalties or interest on amounts received during the first 5 taxable years of a company that is principally engaged in research activities. A taxpayer would be considered to be principally engaged in research activities during a taxable year if (1) the taxpayer has three full-time employees substantially all of whose services are direct related to such business, (2) research expenses, trade or business expenses, and start-up expenses exceed 80 percent of gross income for such business, and (3) research and experimental expenditures are at least 50 percent of the total of research expenses, trade or business expenses, and start-up expenses.

Treatment of deferred pre-1987 minimum tax

Net operating loss carryovers to post-1986 years would not be reduced for purposes of the corporate alternative minimum tax by reason of pre-1987 tax preferences for research and experimental expenditures.

Effective Dates

The part of the proposal applying to the tax treatment of start-up costs and the part of the proposal applying to the calculation of personal holding company taxable income would apply for taxable years beginning after December 31, 1989. The two parts of the proposal relating to the alternative minimum tax would apply as if they were included in the Tax Reform Act of 1986. The part of the proposal applying to net operating losses of qualified research companies would apply to ownership changes occurring after December 31, 1989.

5. Certain family-owned corporations eligible to elect Subchapter S treatment

Present Law

Under present law, a small business corporation may elect to be treated as an S corporation. Income and losses of an S corporation are generally passed through to its shareholders and taxed at the shareholder level rather than at the corporate level. A small business corporation may not have more than 35 shareholders. For this purpose, a husband and wife (and their estates) are counted as one shareholder.

Explanation of Proposal

Under the proposal, a brother and sister (and their estates) would be counted as one shareholder for purposes of counting the number of shareholders in a small business corporation. This rule would apply only if all of the stock of the corporation is owned by members of the same family. A family means the lineal descendants (and their spouses) of a common ancestor.[4]

Effective Date

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

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[4] The proposal does not specify the number of generations of descendents that may qualify as a family.

C. Hedging Transactions by Real Estate Investment Trusts

Present Law

In order for an entity to qualify as a real estate investment trust ("REIT"), at least 95 percent of its gross income generally must be derived from certain passive sources and real estate assets (the "95-percent test"). Also, with certain exceptions, less than 30 percent of the gross income of a REIT must be derived from the sale or exchange of certain assets, including real property held for less than four years (the "30-percent test").

For purposes of determining whether an entity qualifies as a REIT, the Code provides specific rules for the treatment of interest rate swap or cap agreements that protect the REIT from interest rate fluctuations on variable interest rate debt incurred to acquire or carry real estate assets. Such agreements are treated as securities under the 30-percent test and payments under them are treated as qualifying under the 95-percent test.

Explanation of Proposal

The present-law treatment of interest rate swap or cap agreements would be extended to similar arrangements, such as forward rate agreements and futures contracts. In addition, in determining whether an arrangement hedges variable rate indebtedness, a REIT holding a residual interest in a real estate mortgage investment conduit ("REMIC") would be treated as holding the REIT's proportionate share of the REMIC's assets and the REIT's proportionate share of the regular interests of the REMIC would be treated as direct indebtedness of the REIT.

Effective Date

The proposal would be effective with respect to taxable years beginning after December 31, 1989.

D. Financial Institutions

1. Modification of tax treatment of interests in certain regulated investment companies held by financial institutions

Present Law

Treatment of gain or loss with respect to indebtedness held by certain financial institutions

In general, the sale or exchange of a security is considered the sale or exchange of a capital asset. However, the sale or exchange of a bond, debenture, note, or certificate or other evidence of indebtedness by a commercial bank, thrift institution, small business investment company, or any business development corporation is not considered a sale or exchange of a capital asset. Securities to which this treatment applies include any regular or residual interest in a real estate mortgage investment conduit ("REMIC") (Code sec. 582(c)).

Definition of thrift institution

Thrift institutions are granted more favorable tax treatment in computation of their bad debt deductions than commercial banks or other taxpayers if their assets meet certain requirements. In order to be eligible for this favorable treatment, a thrift institution must hold 60 percent of its assets as "qualifying assets" (generally cash, government obligations, and loans secured by residential real property including any regular or residual interest in a REMIC) (Code secs. 593(a)(2) and 7701(a)(19)).

Explanation of Proposal

Treatment of gain or loss with respect to indebtedness held by certain financial institutions

The proposal would expand the definition of securities qualifying for ordinary income or loss treatment to shares of a qualified regulated investment company (RIC). A qualified RIC would be defined as any RIC whose portfolio consists of assets at least 95 percent of which are bonds, debentures, notes, or certificates or other evidences of indebtedness.

Definition of thrift institution

The definition of qualifying assets would be expanded to include shares of a RIC, but only in the proportion in which the assets of such RIC consist of qualifying assets. If 95 percent or more of the assets of a RIC are qualifying assets, then 100 percent of each share of such RIC would be treated as a qualifying asset.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1989.

2. Alternative recapture method for mutual savings banks changing from the reserve method to the specific charge-off method for bad debts

Present Law

Under present law, a thrift institution (i.e., a building and loan association, mutual savings bank, or cooperative bank) is permitted a deduction for a reasonable addition to a reserve for bad debts if at least 60 percent of its assets are invested in qualified assets (including home mortgages) (Code secs. 593(a)(2) and 7701(a)(19)). The reasonable addition to the reserve for bad debts for a thrift institution is an amount computed under the experience method or an amount equal to 8 percent of its otherwise taxable income. The amount of bad debt reserves are recaptured if the thrift institution is liquidated in a taxable transaction or makes dividend distributions in excess of post-1951 earnings (Code sec. 593(e)).

A commercial bank whose average adjusted bases of all assets does not exceed $500 million (i.e., a "small bank") also is allowed a deduction for a reasonable addition to a reserve for bad debts. The reasonable addition to the reserve is an amount computed under the experience method (Code sec. 585)).

A bank whose average adjusted bases of all assets exceeds $500 million (i.e., a "big bank") is not permitted any deduction for an addition to a reserve for bad debts (code sec. 585(c)). Instead, such banks may deduct specific bad debts only in the year in which they become worthless or partially worthless (the "specific charge-off method"). In addition, big banks are required to recapture their existing bad debt reserves under one of two methods. Under the first method (called the "4-year recapture method"), the balance of the reserve generally is recaptured at the following rates: 10 percent in the first year, 20 percent in the second year, 30 percent in the third year, and 40 percent in the fourth year (Code sec. 585(c)(3)(A)). Under the second method (called the "cut-off method"), specific bad debts on loans made before the change in method are charged to the reserve. Then, the balance of the reserve is recaptured as the reserve balance exceeds the amount of pre-change loans that remain outstanding (Code sec. 585(c)(4)).

Explanation of Proposal

A mutual savings bank that changes from the reserve method of accounting for bad debts to the specific charge-off method would be allowed to elect to recapture only the so-called "experience portion" of its bad debt reserves under the "4-year recapture method" applicable to commercial banks. The experience portion of the bad debt reserve is based on the institution's actual bad debts as a percentage of its loans outstanding over a 6-year period. However, if the sum of the specific bad debts at the end of any year on loans held by the taxpayer before the accounting method change exceed the cumulative amount of reserves required to be recaptured by the end of that year, the excess would not be deducted, but would be charged to the unrecaptured portion of the bad debt reserves (similar to the "cut-off method"). In addition, any remaining bad debt reserves would be recaptured when excessive dividends are paid by the savings bank or upon partial or complete liquidation of the savings bank (under the rules of Code sec. 593(e)).

The proposal could be expanded to cover all thrift institutions (i.e., savings and loan institutions and cooperative banks).

Effective Date

The proposal would be effective for taxable years ending after the date of enactment.

E. Excise Tax: Modifications to Alcohol Occupational Taxes

Present Law

Occupational tax structure

Proprietors which produce or sell alcoholic beverages, i.e., beer, wine, and distilled spirits, are subject to an annual occupational tax. The present levels of occupational taxes were enacted in the Omnibus Budget Reconciliation Act of 1987, and became effective on January 1, 1988.

An exception from the tax is provided for a plant which is used to produce distilled spirits exclusively for fuel use and which produces no more than 10,000 proof gallons per year.

The annual occupational tax applicable to each of the different occupational activities is presented in the following table.

Occupation	Tax
Large producers........................	$1,000
Small producers (gross receipts below $500,000)......	500
Wholesalers............................	500
Drawbackers............................	500
Industrial users.......................	250
Retailers..............................	250

The taxable year for the alcohol occupational taxes is July 1 through June 30.

Back tax liability, penalties and interest

Since the occupational taxes have been increased and administrative responsibility for alcohol taxes has been transferred to the Bureau of Alcohol, Tobacco and Firearms, enforcement activities have been intensified. As a result, some taxpayers were located who had not paid occupational taxes for a number of years. Many of the delinquent taxpayers claim to have been unaware of the existence of the occupational taxes. Nevertheless, they have been assessed for back taxes plus interest and penalties.

Explanation of Proposal

Occupational tax structure

The annual occupational tax structure would be revised, as shown in the following table, to redistribute the burden among the several occupations. Retailers would pay $85 less annually, and the tax on the other occupations generally would be increased.

Occupation	Tax Rate Current	Proposed
Large producers........................	$1,000	$5,000
Small producers........................	500	2,500
Wholesalers............................	500	2,000
Drawbackers............................	500	5,000
Industrial users.......................	250	250
Retailers..............................	250	165

Back tax liability, penalties and interest

Interest and penalties for nonpayment of the annual alcohol occupational taxes would not apply for periods prior to July 1, 1989, provided that payment for all delinquent taxes is made by July 1, 1991.

Effective Dates

The revised occupational tax structure would be effective on July 1, 1990.

The adjustment on back taxes would be effective on the date of enactment.

F. Energy Tax Provisions

1. Repeal the percentage depletion 65-percent taxable income limitation for all or certain property

Present Law

Under present law, independent oil producers and royalty owners (but not integrated oil companies) recover certain costs incurred prior to drilling an oil- or gas-producing property using the higher of cost or percentage depletion. Under percentage depletion, 15 percent of the taxpayer's gross income from the property is allowed as a deduction in each taxable year. The amount deducted may not exceed 50 percent of the taxable income from the property for the taxable year, computed without regard to the depletion deduction. Additionally, the depletion for all oil and gas properties may not exceed 65 percent of the taxpayer's overall taxable income (determined with certain adjustments).

Explanation of Proposal

Under the proposal, the 65-percent taxable income limitation would be repealed.

Alternatively, the 65-percent taxable income limitation would be repealed for marginal production. For this purpose, marginal production would include production from "stripper wells" and heavy oil.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1989.

2. Repeal the percentage depletion "anti-transfer" rule for all or certain property

Present Law

Under present law, percentage depletion for oil and gas properties for independent producers and royalty owners is limited to 1,000 barrels of average daily domestic crude oil production (or an equivalent amount of natural gas). If an interest in a proven oil or gas property is transferred after 1974, production from that interest generally does not qualify for percentage depletion.

Explanation of Proposal

Under the proposal, percentage depletion for oil and gas would be allowed for transferred properties.

Alternatively, percentage depletion for oil and gas would be allowed for marginal properties transferred.

Effective Date

The proposal would be effective for transfers on or after January 1, 1990.

3. Modification of tax preference for intangible drilling costs in the alternative minimum tax

Present Law

Under present law, domestic intangible drilling costs (IDCs) generally may either be currently expensed or else may be capitalized and recovered through depletion or depreciation deductions (as appropriate), at the election of the taxpayer. In general, IDCs include expenditures by the property owner incident to and necessary for the drilling and preparation of wells for the production of oil and gas which are neither for the purchase of tangible property nor part of the acquisition price of an interest in the property. IDCs include amounts paid for labor, fuel, repairs, and site preparation.

Taxpayers are subject to an alternative minimum tax which is payable, in addition to all other tax liabilities, to the extent it exceeds the taxpayer's regular tax. The tax is calculated with respect to alternative minimum taxable income, which is generally the taxpayer's taxable income, as increased or decreased by certain adjustments and preferences. IDC deductions on successful oil and gas wells are a tax preference item for this purpose, to the extent that the taxpayer's "excess IDCs" exceed 65 percent of the taxpayer's net income from oil and gas properties. Excess IDCs are defined generally as (1) IDC deductions (attributable to successful wells) for the taxable year minus (2) the amount that would have been capitalized and recovered over a 10-year straight line amortization period. At the election of the operator, the cost depletion method may be substituted for the 10-year amortization schedule in determining the amount of the tax preference.

Explanation of Proposal

The proposal would eliminate 80 percent of the present law minimum tax preference item for IDCs attributable to exploratory drilling incurred by independent producers.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1989.

4. Definition of "independent producer" for purposes of oil and gas percentage depletion rules

Present Law

Under present law, integrated oil companies are not allowed percentage depletion for oil and gas production. An integrated oil company includes (1) taxpayers who sell oil or natural gas through retail outlets in excess of $5 million per year, and (2) taxpayers who engage in refining more than 50,000 barrels of crude oil on any day of the year. Activities of a related party are attributed to the taxpayer for this purpose. A person is related to the taxpayer if a third party holds a "significant ownership interest" (i.e., a 5 percent or more equity interest, directly or indirectly) in both the taxpayer and the other party.

Explanation of Proposal

The proposal would provide that for purposes of determining whether a person is an integrated oil company, an interest owned by a trust exempt from tax by reason of Code section 501(c)(3) would not be treated as a significant ownership interest.

Effective Date

The proposal would be effective on the date of enactment.

5. Tax credit for alternative-fuels vehicles

Present Law

The investment tax credit was repealed in the Tax Reform Act of 1986. Purchases of automobiles were eligible for the credit when also deductible as an expense incurred for the production of income. Energy tax credits under present law do not apply to the production of alternative fuels.

Alcohol fuels are eligible for a credit of 60 cents per gallon for a manufacturer or a blender when the alcohol is used as a fuel in a trade or business or is sold for use in a fuel mixture at retail. Alternatively, there is a refund or credit of 6 cents per gallon for gasohol sold at retail.

Alcohol for this purpose includes methanol and ethanol but does not include alcohol produced from petroleum, natural gas, or coal (including peat).

Explanation of Proposal

An investment tax credit would be made available at the air quality percentage for qualified clean-burning motor vehicle property. The applicable air quality percentage (and tax credit) would be:

20 percent for January 1, 1990, to December 31, 1999
15 percent for January 1, 2000, to December 31, 2000
10 percent for January 1, 2001, to December 31, 2001
5 percent for January 1, 2002, to December 31, 2002

The credit would expire after December 31, 2002.

Qualified clean-burning motor vehicle fuel property is property that will enable a motor vehicle to be propelled by a clean-burning fuel. Such property includes (1) equipment designed to modify a motor vehicle to be able to use a clean-burning fuel, (2) the portion of basis of a motor vehicle propelled only by clean-burning fuel attributable to the storage or delivery to the engine of the fuel or the exhaust of gases from combustion, and (3) equipment related to the storage and delivery of a clean-burning fuel into the tank of a qualified motor vehicle.

Clean-burning fuel means natural gas, liquefied petroleum gas, and any fuel which is at least 85 percent methanol, ethanol, or ether.

The basis of clean-burning motor vehicle property would not be reduced by the amount of the clean-burning fuels credit.

A State or any of its political subdivisions would be eligible to file a claim for the clean-burning fuels credit for a taxable year, if all qualified property were used in a trade or business and the eligible governmental unit were subject to income tax.

Effective Date

The proposal would apply to periods after December 31, 1989.