

**DESCRIPTION OF CHAIRMAN'S MARK FOR
THE PROVISIONS OF H.R. 3286
RELATING TO
TAX CREDIT FOR ADOPTION EXPENSES AND
CERTAIN REVENUE OFFSETS AND THE
REMOVAL OF BARRIERS TO INTERETHNIC ADOPTIONS**

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CONTENTS

	<u>Page</u>
INTRODUCTION	1
I. REVENUE PROVISIONS	2
A. Tax Credit and Exclusion for Adoption Expenses	2
B. Revenue Offsets	5
1. Treatment of bad debt deductions of thrift institutions	5
2. Depreciation under the income forecast method	7
II. REMOVAL OF BARRIERS TO INTERETHNIC ADOPTION	10

INTRODUCTION

The Senate Committee on Finance has scheduled a markup on H.R. 3286 ("Adoption Promotion and Stability Act of 1996") on June 12, 1996. H.R. 3286 was passed by the House on May 10, 1996.

As passed by the House, Title I of the bill would provide a tax credit for certain adoption expenses and an exclusion for certain employer-provided adoption expenses; Title II of the bill would remove certain barriers to interethnic adoptions; Title III of the bill would modify child custody proceedings affected by the Indian Child Welfare Act of 1978; and Title IV of the bill would provide two revenue offsets: (1) remove business exclusion for energy subsidies provided by public utilities, and (2) modify treatment of foreign trusts.

Part I of this document,¹ prepared by the staff of the Joint Committee on Taxation, provides a description of the Finance Committee Chairman's mark for the provisions of H.R. 3286 relating to a tax credit for adoption expenses and proposals to modify (1) the treatment of bad debt deductions of thrift institutions and (2) the depreciation rules under the income forecast method of accounting. Part II of the document contains a description of a provision to remove barriers to interethnic adoptions.

After consideration of the bill by the Finance Committee, it will be referred to the Indian Affairs Committee for a period of 10 legislative days for consideration of Title III of the bill.

¹ This document may be cited as follows: Joint Committee on Taxation, *Description of Chairman's Mark for the Provisions of H.R. 3286 Relating to Tax Credit for Adoption Expenses and Certain Revenue Offsets and the Removal of Barriers to Interethnic Adoptions* (JCX-24-96), June 11, 1996.

I. REVENUE PROVISIONS

A. Tax Credit and Exclusion for Adoption Expenses

Present Law

Under present law, 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) 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), could not reasonably be expected to be adopted unless adoption assistance is provided. 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 nonrecurring costs directly associated with the adoption process such as legal costs, social service review, and transportation costs.

Present law provides no specific Federal tax benefits to encourage adoption.

Description of Proposal

Tax credit

The proposal would provide taxpayers with a maximum nonrefundable credit against income tax liability of \$5,000 per child for qualified adoption expenses paid or incurred by the taxpayer. In the case of a special needs adoption, the maximum credit amount would be \$6,000. Any unused adoption credit could be carried forward by the taxpayer for up to five years. 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 an eligible child. All reasonable and necessary expenses required by a State as a condition of adoption would be qualified adoption expenses. For example, expenses could include the cost of construction, renovations, alterations or purchases specifically required by the State to meet the needs of the child. In the case of an international adoption, the credit would not be available unless the adoption is finalized. An eligible child would be an individual (1) who has not attained age 18 as of the time of the adoption, or (2) who is physically or mentally incapable of caring for himself or herself. After December 31, 2000, the credit would be available only for special needs adoptions. No credit would be allowed for expenses incurred (1) in violation of State or Federal law, (2) in carrying out any surrogate parenting arrangement, or (3) in connection with the adoption of a child of the taxpayer's spouse. The credit would be phased out ratably for taxpayers with modified adjusted gross income (AGI) above \$75,000, and would be fully phased out at \$115,000 of modified AGI.

The \$5,000 limit would be a per child limit, not an annual limitation. For example, if a taxpayer incurs \$3,000 of qualified adoption expenses in year one and \$3,000 of qualified adoption expenses in year two, then the taxpayer would receive a \$3,000 credit in year one and a \$2,000 credit in year two.

To avoid a double benefit, the proposal would deny the credit to taxpayers to the extent the taxpayer may use otherwise qualified adoption expenses as the basis of another credit or deduction. Similarly, the credit would not be allowed for any expenses for which a grant is received under any Federal, State, or local program. This denial of the credit would also apply in the case of special needs adoptions.

The proposal would 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 from each other 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 of the taxable year and (2) furnished over one-half of the cost of maintaining that household in that taxable year. Further, the proposal would provide that an individual legally separated from his, or her, spouse under a decree of divorce or separate maintenance would not be considered married for purposes of this provision.

Exclusion from income

The proposal would provide a maximum \$5,000 exclusion from the gross income of an employee for qualified adoption expenses (as defined above) paid by the employer. The \$5,000 limit would be a per child limit, not an annual limitation. In the case of a special needs adoption, the maximum exclusion from income would be \$6,000. No exclusion would be allowed for expenses paid by an employer after December 31, 2000. In order for the exclusion to apply, the expenses would have to be paid under an adoption assistance program in connection with an adoption of an eligible child (as described above) by an employee.

An adoption assistance program would be a nondiscriminatory plan of an employer under which the employer provides employees with adoption assistance. Also, not more than five percent of the benefits under the program for any year could benefit a class of individuals consisting of more than five percent owners of the employer or their spouses or dependents. An adoption assistance program would not be required to be funded. An adoption reimbursement program operated under section 1052 of title 10 of the U.S. Code (relating to the armed forces) or section 514 of title 14 of the U.S. Code (relating to members of the Coast Guard) would be treated as an adoption assistance program for these purposes. Adoption assistance would be a qualified benefit under a cafeteria plan. The exclusion would be phased out ratably for taxpayers with modified AGI above \$75,000 and would be fully phased out at \$115,000 of modified AGI. Employees would not be entitled to claim the adoption tax credit with respect to excludable adoption expenses paid or reimbursed under an employer's adoption assistance program.

Treasury study

The Secretary of the Treasury would be directed to prepare a study of the effect of the tax credit and exclusion on adoptions to be submitted to the House Committee on Ways and Means and the Senate Finance Committee by January 1, 2000.

Effective Date

The provision would be effective for taxable years beginning after December 31, 1996.

B. Revenue Offsets

1. Treatment of bad debt deductions of thrift institutions

Present Law

Generally, a taxpayer engaged in a trade or business may deduct the amount of any debt that becomes wholly or partially worthless during the year (the "specific charge-off" method of sec. 166). Certain thrift institutions (building and loan associations, mutual savings banks, or cooperative banks) are allowed deductions for bad debts under methods more favorable than those granted to other taxpayers (and more favorable than the rules applicable to other financial institutions). Qualified thrift institutions may compute deductions for bad debts using either the specific charge-off method or the reserve method of section 593.

Under section 593, a thrift institution annually may elect to deduct bad debts under either (1) the "percentage of taxable income" method applicable only to thrift institutions, or (2) the "experience" method that also is available to small banks. Under the "percentage of taxable income" method, a thrift institution generally is allowed a deduction for an addition to its bad debt reserve equal to 8 percent of its taxable income (determined without regard to this deduction and with additional adjustments). Under the experience method, a thrift institution generally is allowed a deduction for an addition to its bad debt reserve equal to the greater of: (1) an amount based on its actual average experience for losses in the current and five preceding taxable years, or (2) an amount necessary to restore the reserve to its balance as of the close of the base year.

If a thrift institution becomes ineligible to use the section 593 method, it is required to change its method of accounting for bad debts and, under proposed Treasury regulations, is required to recapture all or a portion of its bad debt reserve. In addition, a thrift institution eligible to use the section 593 method may be subject to a form of reserve recapture if the institution makes certain excessive distributions to its shareholders (sec. 593(e)).

Description of Proposal

The proposal would repeal the section 593 reserve method of accounting for bad debts by thrift institutions, effective for taxable years beginning after 1995. Thrift institutions that qualify as small banks would be allowed to use the experience method applicable to such banks, while thrift institutions that are treated as large banks are required to use the specific charge-off method.

A thrift institution required to change its method of computing reserves for bad debts under the proposal would treat such change as a change in a method of accounting, initiated by the taxpayer, and having been made with the consent of the Secretary of the Treasury. Any section 481(a) adjustment required to be taken into account with respect to such change generally is to be determined solely with respect to the "applicable excess reserves" of the

taxpayer. The amount of applicable excess reserves would be taken into account ratably over a 6-taxable year period, beginning with the first taxable year beginning after 1995, subject to the residential loan requirement described below. In the case of a thrift institution that becomes a "large bank" (as determined under sec. 585(c)(2)), the amount of the institution's applicable excess reserves generally would be the excess of (1) the balance of its reserves described in section 593(c)(1) (other than its supplemental reserve for losses on loans) as of the close of its last taxable year beginning before January 1, 1996, over (2) the balance of such reserves as of the close of its last taxable year beginning before January 1, 1988 (i.e., the "pre-1988 reserves"). Similar rules would be provided for "small banks" and for small banks that subsequently become large banks.

The pre-1988 reserves of a thrift institution would be restored to income ratably if the institution ceased to be a bank. A thrift institution that becomes a credit union would be not be treated as a bank and any reserves required to be included in income by the credit union would be treated as unrelated trade or business income.

The balance of the pre-1988 reserves would continue to be subject to the provisions of section 593(e) (requiring recapture in the case of certain excess distributions to, and redemptions of, shareholders). Section 593(e) would not apply to certain internal restructurings of an affiliated group of banks.

Under a special rule, if the taxpayer meets the "residential loan requirement" for a taxable year, the recapture of the applicable excess reserves otherwise required to be taken into account as a section 481(a) adjustment for such year would be suspended. A taxpayer would meet the residential loan requirement if, for the taxable year, the principal amount of residential loans made by the taxpayer during the year is not less than its base amount. The "base amount" of a taxpayer would be the average of the principal amounts of the residential loans made by the taxpayer during the six most recent taxable years beginning before January 1, 1996. At the election of the taxpayer, the base amount could be computed by disregarding the taxable years within that 6-year period in which the principal amounts of loans made during such years were highest and lowest. The test would be applied on a controlled group basis. The residential loan requirement would be applicable only for taxable years that begin after December 31, 1995, and before January 1, 1998, and must be applied separately with respect to each such year. Thus, all taxpayers would be required to recapture their applicable excess reserves within six, seven, or eight years after the effective date of the provision.

Effective Date

The provision generally would be effective for taxable years beginning after December 31, 1995. Taxpayers with applicable excess reserves that make distributions with respect to preferred stock within a specified period of time would treat such distributions in a manner similar to the treatment provided under present-law section 593(e).

2. Depreciation under the income forecast method

Present Law

Depreciation and amortization, in general

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through allowances for depreciation or amortization. Depreciation deductions are allowed under section 167 and the amounts of such deductions are determined under the modified Accelerated Cost Recovery System ("MACRS") of section 168 for most tangible property. MACRS determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property. Intangible property generally is amortized under section 197, which applies a 15-year recovery period and the straight-line method to the cost of applicable property.

Treatment of film, video tape, and similar property

MACRS does not apply to certain property, including (1) any motion picture film, video tape, or sound recording or (2) any other property if the taxpayer elects to exclude such property from MACRS and the taxpayer applies a unit-of-production method or other method of depreciation not expressed in a term of years. Likewise, section 197 does not apply to certain intangible property, including property produced by the taxpayer or any interest in a film, sound recording, video tape, book or similar property unless acquired as part of a trade or business. Thus, the cost of a film, video tape, or similar property that is produced by the taxpayer or is acquired on a "stand-alone" basis by the taxpayer may not be recovered under either the MACRS depreciation provisions or under the section 197 amortization provisions. The cost of such property may be depreciated under the general depreciation provision of section 167, which allows deductions for the reasonable allowance for the exhaustion, wear and tear, or obsolescence of the property.

The "income forecast" method is an allowable method for calculating depreciation under section 167 for certain property. The income forecast method attempts to match allocable portions of the cost of property with the income expected to be generated by the property. Specifically, under the income forecast method, the depreciation deduction for a taxable year for a property is determined by multiplying the cost of the property (less estimated salvage value) by a fraction, the numerator of which is the income generated by the property during the year and the denominator of which is the total forecasted or estimated income to be derived from the property during its useful life. The income forecast method has been held to be applicable for computing depreciation deductions for motion picture films, television films and taped shows, books, patents, master sound recordings and video games. The total forecasted or estimated income to be derived from a property is to be based on the conditions known to exist at the end of the period for which depreciation is claimed. This estimate can be revised upward or downward at the end of a subsequent taxable period based on additional information that becomes available after the last prior estimate. These revisions, however, do not affect the

amount of depreciation claimed in a prior taxable year. Thus, unforeseen income that is generated after the property is fully depreciated is never taken into account under the income forecast method.

In the case of a film, income to be taken into account under the income forecast method means income from the film less the expense of distributing the film, including estimated income from foreign distribution or other exploitation of the film. In the case of a motion picture released for theatrical exhibition, income does not include estimated income from future television exhibition of the film (unless an arrangement for domestic television exhibition has been entered into before the film has been depreciated to its reasonable salvage value). In the case of a series or a motion picture produced for television exhibition, income does not include estimated income from domestic syndication of the series or the film (unless an arrangement for syndication has been entered into before the series or film has been depreciated to its reasonable salvage value). The Internal Revenue Service also has ruled that income does not include net merchandising revenue received from the exploitation of film characters.

Description of Proposal

The proposal would make several amendments to the income forecast method of determining depreciation deductions.

First, the proposal would provide that income to be taken into account under the income forecast method includes all estimated income generated by the property. In applying this rule, a taxpayer generally need not take into account income expected to be generated more than ten years after the year the property was placed in service. In addition, pursuant to a special rule, in the case of television and motion picture films, the income from the property shall include income from the financial exploitation of characters, designs, scripts, scores, and other incidental income associated with such films, but only to the extent the income is earned in connection with the ultimate use of such items by, or the ultimate sale of merchandise to, persons who are not related to the taxpayer (within the meaning of sec. 267(b)). Finally, pursuant to another special rule, if a taxpayer produces a television series and initially does not anticipate syndicating the episodes from the series, the forecasted income for the episodes of the first three years of the series need not take into account any future syndication fees (unless the taxpayer enters into an arrangement to syndicate such episodes during such period). The 10-year rule, the financial exploitation rule, and the syndication rule would apply for purposes of the look-back method described below.

In addition, the cost of property subject to depreciation would only include amounts that satisfy the economic performance standard of section 461(h). Except as provided in regulations, any costs that are not recovered by the end of the tenth taxable year after the property was placed in service may be taken into account as depreciation in such year.

Finally, taxpayers that claim depreciation deductions under the income forecast method would be required to pay (or would receive) interest based on the recalculation of depreciation

under a "look-back" method. The "look-back" method would be applied in any "recomputation year" by: (1) comparing depreciation deductions that had been claimed in prior periods to depreciation deductions that would have been claimed had the taxpayer used actual, rather than estimated, total income from the property; (2) determining the hypothetical overpayment or underpayment of tax based on this recalculated depreciation; and (3) applying the overpayment rate of section 6621 of the Code. Except as provided in regulations, a "recomputation year" would be the third and tenth taxable year after the taxable year the property was placed in service unless the actual income from the property for each period before the close of such years was within 10 percent of the estimated income from the property for such periods. The Secretary of the Treasury would have the authority to allow a taxpayer to delay the initial application of the look-back method where the taxpayer may be expected to have significant income from the property after the third taxable year after the taxable year the property was placed in service (e.g., the Secretary may exercise such authority where the depreciable life of the property is expected to be longer than three years). Property with an adjusted basis of \$100,000 or less when the property was placed in service would not be subject to the look-back method. The proposal would provide a simplified look-back method for pass-through entities.

Effective Date

The provision would be effective for property placed in service after September 13, 1995, unless placed in service pursuant to a binding written contract in effect on such date and all times thereafter.

II. REMOVAL OF BARRIERS TO INTERETHNIC ADOPTION

Present Law

State law governs adoption and foster care placement. Many States permit race matching of foster and adoptive parents with children either by regulation, statute, policy, or practice. The Howard M. Metzenbaum Multiethnic Placement Act of 1994, Public Law 103-382 ("Metzenbaum Act"), permits States to consider race and ethnicity in selecting a foster care or adoptive home, but States cannot delay or deny the placement of the child solely on the basis of race, color, or national origin.

Noncompliance with the Metzenbaum Act is deemed a violation of Title VI of the Civil Rights Act of 1964.

Description of Proposal

Under H.R. 3286, "race, color or national origin" could not be used to delay or deny the placement of a child into a foster or adoptive placement. Under H.R. 3286, section 558 of the Metzenbaum Act would be repealed. In addition, the proposal would amend the State plan requirements of section 471 of the Social Security Act to prohibit a State or other entity that receives Federal assistance from denying to any person the opportunity to become an adoptive or a foster parent on the basis of the race, color, or national origin of the person or of the child involved. Similarly, no State or other entity receiving Federal funds could delay or deny the placement of a child for adoption or foster care in making a placement decision, on the basis of the race, color, or national origin of the adoptive or foster parent or the child involved.

Section 474 of the Social Security Act would be amended to require the Secretary of Health and Human Services ("HHS") to reduce the amount of Federal foster care and adoption funds provided to the State through Title IV-E if the State program is found in violation of this provision as a result of a review conducted under section 1123 of the Social Security Act. States found to be in violation would have their quarterly funds reduced by 2 percent for the first violation, by 5 percent for the second violation, and by 10 percent for the third or subsequent violation.

The proposal clarifies that the Secretary of HHS shall apply penalties in conformance with section 1123 procedures. The proposal clarifies that penalties will be assessed on a fiscal year basis. It modifies H.R. 3286 by limiting to 25 percent the maximum amount the Secretary of HHS can reduce a State's grant in a quarter.

Private entities found to be in violation of this provision for a quarter would be required to return to the Secretary of HHS all federal funds received from the State during the quarter.

Any individual who is harmed by a violation of H.R. 3286 could seek redress in any United States District Court. An action under this proposal could not be brought more than two

years after the alleged violation occurred.

Noncompliance with H.R. 3286 would constitute a violation of Title VI of the Civil Rights Act of 1964. The Indian Child Welfare Act of 1978 would not be affected by changes made H.R. 3286.

Effective Date

The provision related to civil rights enforcement are effective upon enactment. The provisions related to State plan requirements would be effective on January 1, 1997.