DESCRIPTION OF THE "CONTRACT WITH AMERICA TAX RELIEF ACT OF 1995"

Scheduled for Markup

by the

HOUSE COMMITTEE ON WAYS AND MEANS

Beginning on March 14, 1995

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

March 9, 1995

JCX-9-95★

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the "Contract With America Tax Relief Act of 1995." The House Committee on Ways and Means has scheduled a markup of these provisions beginning on March 14, 1995. The "Contract With America Tax Relief Act of 1995" includes provisions derived from the revenue provisions contained in the "Contract With America" (the "Contract"), as well as certain other revenue proposals.

The Contract was signed by over 300 Republican House candidates and incumbents on September 27, 1994, as an agenda for the first 100 days of the 104th Congress. The Contract was introduced when the 104th Congress convened on January 4, 1995, and includes four bills that contain various tax proposals: H.R. 6 ("American Dream Restoration Act"), H.R. 8 ("Senior Citizens' Equity Act"); H.R. 9 ("Job Creation and Wage Enhancement Act"); and H.R. 11 ("Family Reinforcement Act").

Part I of this document describes tax provisions derived from the American Dream Restoration Act. Part II contains a description of tax provisions derived from the Senior Citizens' Equity Act. Part III describes tax provisions derived from the Job Creation and Wage Enhancement Act, with additional proposals regarding a 25-percent corporate alternative tax for capital gains, the treatment of leasehold improvements, and the alternative minimum tax. Part IV of this document contains a description of tax provisions derived from the Family Reinforcement Act; Part V describes a proposal to increase the social security earnings limit derived from the Senior Citizens' Equity Act; and Part VI relates to the provisions of H.R. 1121, the "Tax Technical Corrections Act of 1995," introduced on March 3, 1995 with certain modifications..

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of the "Contract With America Tax Relief Act of 1995"* (JCX-9-95), March 9, 1995.

DESCRIPTION OF PROVISIONS

I. THE AMERICAN DREAM RESTORATION TAX ACT (TITLE I)

A. Family Tax Credit

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 Provision

The provision would provide taxpayers with a maximum nonrefundable 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. For purposes of this AGI test, the taxpayer's AGI would be increased by the amount otherwise excluded from gross income under Code sections 911, 931, or 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands; and residents of Puerto Rico, respectively). In calendar years beginning after 1996, the maximum credit amount ($500) and the beginning point of the phaseout range ($200,000) would be indexed annually for inflation with rounding to the nearest $50. The size of the phaseout range would change as needed so as to remain 100 times the maximum

amount of the credit per child.

To be a qualifying child, an individual would have to satisfy a relationship test, a dependency test, and an age test. An individual would satisfy the relationship test if the individual is a son or daughter of the taxpayer, a descendant of a son or daughter of the taxpayer, a stepson or stepdaughter of the taxpayer, or a foster or adopted child of the taxpayer. A foster child would have to, for the taxable year of the taxpayer, (1) be a member of the taxpayer's household and (2) have as his principal place of abode the home of the taxpayer. 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.

An individual would satisfy the dependency test if the individual is a dependent of the taxpayer with respect to whom the taxpayer is entitled to claim a dependency deduction. For purposes of the above test, the term "dependent" would not include an individual who is a resident of a country contiguous to the United States unless that individual is an adopted child of a taxpayer who is a U.S. citizen or national and, for the taxpayer's taxable year, the individual is a member of the taxpayer's household and has as his principal place of abode the home of the taxpayer.

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 provision 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 of the taxable year and (2) furnished over one-half of the cost of maintaining that household in that taxable year.

Except in the case of a taxable year closed by reason of the taxpayer's death, no credit would be allowable in the case of a taxable year covering a period of less than 12 months.

Effective Date

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

B. Credit to Reduce the Marriage Penalty

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, as a general rule married couples whose earnings are split more evenly than 70-30 suffer a marriage penalty. Married couples whose earnings are largely attributable to one spouse generally receive a marriage bonus.

Under present law, the size of the standard deduction and the bracket breakpoints follow certain customary ratios across filing statuses. The standard deduction and bracket breakpoints for single filers are roughly 60 percent of those for joint filers. The standard deduction and bracket breakpoints for head of household filers are about 83 percent of those for joint filers. With these ratios, unmarried individuals have standard deductions whose sum exceeds the standard deduction they would receive as a married couple filing a joint return. Thus, their taxable income as joint filers may exceed the sum of their taxable incomes as unmarried individuals. Furthermore, because of the way the bracket breakpoints are structured, as joint filers they may have some of their taxable income pushed into a higher marginal tax bracket than when they were not married.

The rate changes in the Revenue Reconciliation Act of 1993 exacerbated the existing marriage penalty because the new bracket breakpoints did not provide the customary ratios across filing statuses. For the new 36-percent bracket, the breakpoint for single filers and for head of household filers are 82 percent and 91 percent, respectively, of the breakpoint for joint filers. For the 39.6-percent bracket that results from the "surtax," the bracket breakpoint is $250,000 regardless of filing status.

Description of Provision

Married couples who file a joint return could be eligible for a nonrefundable credit against their income tax liability. The amount of the credit would be determined based on the earned income of each of the spouses. The Secretary of the Treasury would issue tables calculating the marriage penalty credit applicable for married taxpayers based on the earned incomes of the spouses.

The amount of the credit would be based on the hypothetical tax liabilities that would result if the individual income tax rates applicable to single filers were applied to each spouse's earned income, allowing for one personal exemption and the standard deduction allowed for single filers. The sum of those hypothetical tax liabilities would be compared to the hypothetical tax liability that would result if the individual income tax rates applicable to married couples filing joint returns were applied to the aggregate earned income of the spouses, allowing for two personal exemptions and the standard deduction allowed for joint filers.

If the hypothetical tax liability of the married couple exceeds the sum of the hypothetical tax liabilities of the individual spouses, the married couple would be allowed a nonrefundable tax credit equal to the lesser of that excess or $145, with amounts less than the maximum credit rounded to the nearest $25. If the hypothetical tax liability of the married couple is less than or equal to the sum of the hypothetical tax liabilities of the individual spouses, the married couple would not be allowed the credit.

Effective Date

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

C. American Dream Savings Accounts and Deductible Spousal IRAs

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). In addition, the $2,000 limit is increased to $2,250 in the case of a married taxpayer who files a joint return and makes contributions to an IRA for the benefit of his or her spouse, if the spouse has no compensation or elects to be treated as having no compensation. The $2,250 contribution can be divided in any manner between IRAs for each spouse, except that the maximum contribution to an IRA on behalf of one individual cannot exceed $2,000.

If the individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the $2,000 deduction limit (and the $2,250 spousal IRA 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. Contributions cannot be made to an IRA after age 70-1/2.

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 59-1/2 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.

In general, distributions from an IRA are required to begin at age 70-1/2. An excise tax is imposed if the minimum required distributions are not made. Distributions to the beneficiary of an IRA are generally required to begin within 5 years of the death of the IRA owner, unless the beneficiary is the surviving spouse. Similar rules apply to distributions from tax-qualified pension plans.

Present law imposes a 15-percent excise tax on excess distributions with respect to an individual during any calendar year from qualified retirement plans, tax-sheltered annuities, and IRAs. The purpose of the tax is to limit the total amount that can be accumulated on behalf of a particular individual on a tax-favored basis. In general, excess distributions are defined as the aggregate amount of retirement distributions (i.e., payments from applicable retirement plans) made with respect to an individual during any calendar year to the extent such amounts exceed $150,000 (for 1995). The

dollar limit is indexed for inflation. Special rules apply in the case of lump-sum distributions and post-death distributions.

Description of Provision

Tax-free nondeductible IRAs

The provision would replace present-law nondeductible IRAs with new American Dream Savings accounts ("ADS accounts") to which individuals could make nondeductible contributions. Contributions to an ADS account would be in addition to any contributions that can be made to a deductible 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 in the manner prescribed by the Secretary. 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 each spouse in a married couple could 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 70-1/2. The pre-death minimum distribution rules that apply to IRAs would not apply to ADS accounts, and amounts in ADS accounts would not be taken into account for purposes of the excise tax on excess distributions.

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 period[2] 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 59-1/2, (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 (whether or not qualified distributions) would not be

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[2] 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. As is the case with IRAs generally, contributions to an ADS account could be made for a year by the due date for the individual's tax return for the year (determined without regard to extensions). The 5-year holding period would run from the taxable year in which the individual is deemed to make the contribution.

subject to the 10-percent tax on early withdrawals. Distributions from an ADS account other than qualified distributions or qualified special purpose distributions would be includible in gross income and subject to the 10-percent tax on early withdrawals.

In general, qualified special purpose distributions would be distributions: for the purchase or acquisition of a principal residence of a first-time homebuyer; for qualified higher education expenses; for medical expenses of the taxpayer or the taxpayer's spouse and dependents; or for long-term care insurance premiums treated as medical expenses under the long-term care provisions.

First-time homebuyers would be individuals who did not own an interest in a principal residence during the 3 years prior to the purchase of a home. In order to qualify as a first-time homebuyer distribution, the distribution would have to be used within 60 days to pay the costs of acquiring, contracting, or reconstructing a residence. If there is a delay in acquisition, construction, or reconstruction, the distribution could be redeposited in an ADS account within 120 days without imposition of tax.

Qualified higher education expenses would be tuition, fees, books, supplies and equipment required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or a child or grandchild of the taxpayer at an eligible educational institution (defined as under sec. 135). The amount of qualified higher education expenses would be reduced by any amount excludable from income under the present-law rules relating to education savings bonds (sec. 135).

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.

Deductible contributions to spousal IRAs

The provision would modify the present-law rules relating to deductible IRAs by permitting deductible IRA contributions of up to $2,000 to be made for each spouse (including, for example, a home maker who does not work outside the home) if the combined compensation of both spouses is at least equal to the contributed amount. The provision would not otherwise modify the rules relating to deductible IRAs.

Effective Date

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

II. SENIOR CITIZENS' EQUITY TAX ACT (TITLE II)

A. Repeal of Increase in Income Tax on Social Security Benefits

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 Revenue Reconciliation Act of 1993 ("1993 Act"), 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 individual 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.

Trust funds

Revenues from the income taxation of Social Security and Railroad Retirement Tier 1 benefits attributable to the 1993 Act increase in the portion of benefits included in gross income are credited quarterly to the Medicare Hospital Insurance (HI) Trust Fund. The remainder of the proceeds from the income taxation of Social Security and Railroad Retirement Tier 1 benefits are credited quarterly to the Old-Age and Survivors Insurance Trust Fund, the Disability Insurance Trust Fund, or the Social Security Equivalent Benefit Account (of the Railroad Retirement system), as appropriate.

Description of Provision

In general

The provision 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 percent
1997	65 percent
1998	60 percent
1999	55 percent.

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 provision 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.

Trust funds

Revenues from the income taxation of Social Security and Railroad Retirement Tier 1 benefits attributable to the increased portion of benefits included in gross income under the 1993 Act (as phased out under the provision) would be credited to the Old-Age and Survivors Insurance Trust Fund.

Effective Date

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

B. Treatment of Long-Term Care Insurance and Services

Present Law

In general

Present law generally does not provide explicit rules relating to the tax treatment of long-term care insurance contracts or long-term care services. Thus, the treatment of long-term care contracts and services is unclear. Present law does provide rules relating to medical expenses and accident or health insurance.

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).

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.

A cafeteria plan is an employer-sponsored arrangement under which employees can elect among cash and certain employer-provided qualified benefits. No amount is included in the gross income of a participant in a cafeteria plan merely because the participant has the opportunity to make such an election (sec. 125). Employer-provided accident or health coverage is one of the benefits that may be offered under a cafeteria plan.

A flexible spending arrangement (FSA) is an arrangement under which an employee is reimbursed for medical expenses or other nontaxable employer-provided benefits, such as dependent care. An FSA may be part of a cafeteria plan or provided by an employer outside a cafeteria plan. FSAs are commonly used reimburse employees for medical expenses not covered by insurance. If certain requirements are satisfied, amounts reimbursed for nontaxable benefits from an FSA are excludable from income.

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.

Life insurance company reserve rules

In general, life insurance companies are allowed a deduction for a net increase in reserves and must take into income any net decreases in reserves. Present law prescribes a tax reserve method based on the nature of the contract. For noncancellable accident and health insurance contracts, the prescribed method is a two-year full preliminary term method. Long-term care insurance reserves are treated like noncancellable accident and health insurance for this purpose and, therefore, are subject to the two-year full preliminary term method of reserves. In no event is the tax reserve for any contract as of any time permitted to exceed the amount which would be taken into account in determining statutory reserves (i.e., set forth on the annual statement for State law reporting purposes). Under the National Association of Insurance Commissioners (NAIC) Long-Term Care Insurance Model Act and Regulations, which have been adopted by some States, by contrast, long-term care insurance reserves are calculated under a one-year full preliminary term method. Thus, because of this inconsistency, in some cases life insurance companies establish reserves for long-term care insurance contracts earlier for State regulatory purposes than they do for Federal tax purposes. In addition, some life insurance companies have voluntary complied with the NAIC model act and regulations, even though not required to do so in all cases.

Changes in reserve amounts due to changes in the basis on which reserves are calculated are generally spread over a 10-year period.

Description of Provisions

Tax treatment and definition of long-term care insurance contracts and qualified long-term care services

In general

A long-term care insurance contract would be accorded the following tax treatment. A long-term care insurance contract would be treated as an accident and health insurance contract.[3] Amounts (other than policyholder dividends or premium refunds) received under a long-term care insurance contract would be excludable as amounts received for personal injuries and sickness. A plan of an employer providing coverage under a long-term care insurance contract generally would be treated as an accident and health plan; however, coverage under a long-term care insurance contract would not be excludable by an employee if provided through a cafeteria plan and expenses for long-term care services could not be reimbursed under an FSA.

Within certain limits, premiums for long-term care insurance would be treated as medical expenses for purposes of the itemized deduction for medical expenses. Similarly, expenses for qualified long-term care services would be treated as medical expenses for purposes of the itemized deduction.

Definition of long-term care insurance contract

A long-term care insurance contract would be defined as any insurance contract that provides only coverage of qualified long-term care services and that meets other requirements. The other requirements would be that (1) the contract is guaranteed renewable, (2) the contract does not provide for a cash surrender value or other money that can be paid, assigned, pledged or borrowed, (3) refunds (other than refunds on death of the insured or complete surrender or cancellation of the contract) and dividends under the contract may be used only to reduce future premiums or increase future benefits, and (4) the contract generally does not pay or reimburse expenses reimbursable under Medicare (except where Medicare is a secondary payor, or the contract makes per diem or other periodic payments without regard to expenses). A contract would not fail to be treated as a long-term care insurance contract solely because it provides for payments on a per diem or other periodic basis without regard to expenses during the period. Long-term care insurance contracts would not be subject to the rules requiring duplication of Medicare benefits.

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[3] Prior to December 31, 1993, a self-employed individual was entitled to deduct up to 25 percent of the health insurance expenses for the individual and his or her spouse and dependents. The provision would treat long-term care insurance as health insurance. Thus, if the 25-percent deduction were extended, it would apply to long-term care insurance premiums under the provision.

Definition of qualified long-term care services

Qualified long-term care services would mean necessary diagnostic, preventive, therapeutic, curing, treating, mitigating and rehabilitative services, and maintenance or personal care services that are required by a chronically ill individual and that are provided pursuant to a plan of care prescribed by a licensed health care practitioner.

A chronically ill individual would be one who has been certified within the previous 12 months by a licensed health care practitioner as being unable to perform (without substantial assistance) at least 2 activities of daily living for at least 90 days due to a loss of functional capacity or cognitive impairment, or having a similar level of disability as determined by the Secretary of the Treasury in consultation with the Secretary of Health and Human Services. Activities of daily living would be eating, toileting, transferring, bathing, dressing and continence.

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

Deduction for medical expenses

Unreimbursed expenses for qualified long-term care services provided to the taxpayer or the taxpayer's spouse or dependent would be treated as medical expenses for purposes of the itemized deduction for medical expenses (subject to the present-law floor of 7.5 percent of adjusted gross income). Amounts received under a long-term care insurance contract (regardless of whether the contract reimburses expenses or pays benefits on a per diem or other basis) would be treated as reimbursement for expenses for this purpose. For purposes of this deduction, qualified long-term care services would not include services provided to an individual by a relative or a related corporation.

Within certain limits, long-term care insurance premiums would be treated as medical expenses for purposes of the itemized deduction for medical expenses. The limits are as follows:

In the case of an individual with an attained age before the close of the taxable year of:	**The limitation would be:**
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 1996, these dollar limits would be indexed for increases in the medical care component of the consumer price index. The Treasury Secretary would be directed to develop an index based on increases in skilled nursing facility and home health care costs, that would be substituted for the medical care component of the consumer price index.

Long-term care riders on life insurance contracts

In the case of long-term care insurance coverage provided by a rider on a life insurance contract, the requirements applicable to long-term care insurance contracts would apply as if the portion of the contract providing such coverage were a separate contract. The term "portion" would mean only the terms and benefits that are in addition to the terms and benefits under the life insurance contract without regard to long-term care coverage. The guideline premium limitation and adjustment rules applicable under present law to the life insurance contract would be modified appropriately to take account of charges with respect to the long-term care rider.

Life insurance company reserves

In determining reserves for insurance company tax purposes, the Federal income tax reserve method would be the method prescribed by the National Association of Insurance Commissioners , but no earlier and not in excess of the reserve under the method actually used by the company with respect to the long-term care insurance contract for determining statutory reserves.

Health care continuation rules

The health care continuation rules would not apply to coverage under a long-term care insurance contract.

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

The exchange of a life insurance contract or an endowment or annuity contract for a qualified long-term care insurance contract would not be taxable.

Certain distributions from IRAs and retirement plans for long-term care insurance excludable from income

The provision would exclude from gross income distributions from individual retirement arrangements (IRAs) and distributions attributable to elective deferrals to qualified cash or deferred arrangements (sec. 401(k) plans), tax-sheltered annuities (sec. 403(b) plans), nonqualified deferred compensation plans of governmental or tax-exempt employers (sec. 457 plans), and section 501(c)(18) plans used to pay premiums for long-term care insurance for the individual or the individual's spouse. Such distributions would also not be subject to the 10-percent tax on early withdrawals. Such plans would not fail to meet the qualification requirements applicable to such plans merely because they permit such distributions.

Inclusion of excess long-term care benefits

In general, the provision would provide that the maximum annual amount of long-term care benefits excludable from income with respect to an insured who is chronically ill (but not terminally ill)[4] as of the date the benefit is received could not exceed the equivalent of $200 per day for each day the individual is chronically ill. Thus, the maximum annual exclusion for long-term care benefits with respect to any chronically ill individual (who is not terminally ill) would be $73,000 (for 1996). Long-term care benefits would include benefits paid under a long-term care insurance contract with respect to the insured and benefits excludable from income under the provision relating to accelerated death benefits by reason of the insured being chronically ill (but not terminally ill). If the insured is not the same as the holder of the contract, the insured may assign some or all of this limit to the contract holder at the time and manner prescribed by the Secretary.

This $200 per day limit would be indexed for inflation after 1996 for increases in the medical care component of the consumer price index. The Secretary of the Treasury would be directed to develop an index based on increases in skilled nursing facility and home health care costs that would be substituted for the medical care component of the consumer price index.

A payor of long-term care benefits (as defined above) would be required to report the amount of such benefits.

Effective Date

The provisions defining long-term care insurance contracts and qualified long-term care services would apply to contracts issued after December 31, 1995. Any contract issued before January 1, 1996, that met the long-term care insurance requirements in the State in which the policy

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[4] Terminally ill would be defined as under the provisions relating to accelerated death benefits. In general, under that provision, a person would be considered to be terminally ill if they were certified as having an illness or physical condition that reasonably can be expected to result in death within 24 months of the date of the certification.

was sitused at the time it was issued would be treated as a long-term care insurance contract, and services provided under or reimbursed by the contract would be treated as qualified long-term care services.

A contract providing for long-term care insurance could be exchanged for a long-term care insurance contract (or the former cancelled and the proceeds reinvested in the latter within 60 days) tax-free between the date of enactment and January 1, 1996. Taxable gain would be recognized to the extent money or other property is received in the exchange.

The issuance or conformance of a rider to a life insurance contract providing long-term care insurance coverage would not be treated as a modification or a material change for purposes of applying sections 101(f), 7702 and 7702A of the Code.

The provisions relating to (1) treatment as a medical expense of qualified long-term care insurance services and eligible long-term care premiums and (2) tax-free exchanges of life insurance, endowment and annuity contracts for long-term care insurance contracts, are effective for taxable years beginning after December 31, 1995.

The change in treatment of reserves for long-term care insurance contracts would be effective for contracts issued after December 31, 1995. In the event a company changes its reserve method as set forth on the annual statement for long-term care insurance contracts after that date, the amount of any adjustment arising from the change in tax reserve amounts would be spread over a 10-year period.

The provision relating to certain distributions from IRAs and elective deferrals used to pay long-term care insurance premiums is effective for payments and distributions after December 31, 1995.

The provision relating to the maximum exclusion for long-term care benefits would be effective for taxable years beginning after December 31, 1995.

C. Tax Treatment of Accelerated Death Benefits under Life Insurance Contracts

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.[5] 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 twelve months from the payment of the accelerated death benefit. The proposed regulations do not apply to viatical settlements.

Description of Provision

The provision would provide an exclusion from gross income for (1) any amount received under a life insurance contract and (2) any amount received for the sale or assignment of a life insurance contract to a qualified viatical settlement provider, provided that the insured under the life insurance contract is either terminally ill or chronically ill.

The provision would not apply in the case of an amount paid to any taxpayer other than the insured, if such taxpayer has an insurable interest by reason of the insured being a director, officer or employee of the taxpayer, or by reason of the insured being financially interested in any trade or business carried on by the taxpayer.

Under the provision, an individual would be considered terminally ill if a physician[6] has certified that the individual has an illness or physical condition that reasonably can be expected to result in death within 24 months of the date of certification.

A "chronically ill" individual would be defined as under the separate provision relating to long-term care. With respect to a chronically ill individual (who is not also terminally ill), the $200 per day limitation on excess benefits under the separate long term care provision also would apply to accelerated death benefit payments in a manner reflecting the period that the individual is chronically ill.

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[5] 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 twelve months after payment of the accelerated death benefit.

[6] The term "physician" would have the same meaning as in sec. 1861(r)(1) of the Social Security Act.

A qualified viatical settlement provider would be any person that regularly purchases or takes assignments of life insurance contracts on the lives of terminally ill or chronically ill individuals and either (1) is licensed for such purposes in the State in which the insured resides, or (2) if the person is not required to be licensed by that State, meets the requirements of sections 8 and 9 of the Viatical Settlements Model Act, issued by the National Association of Insurance Commissioners.

For life insurance company tax purposes, the provision would treat a qualified accelerated death benefit rider to a life insurance contract as life insurance. A qualified accelerated death benefit rider would be any rider on a life insurance contract that provides only for payments of a type that are excludable under this provision.

The issuance of a qualified accelerated death benefit rider to a life insurance contract would not be treated as a modification or material change of the contract (and is not intended to affect the issue date of any contract under section 101(f)).

Effective Date

The provision would apply to amounts received after December 31, 1995. The provision treating a qualified accelerated death benefit rider as life insurance for life insurance company tax purposes would be effective on January 1, 1996.

III. JOB CREATION AND WAGE ENHANCEMENT TAX ACT (TITLE III)

A. Capital Gains Provisions

1. 50-percent capital gains deduction for individuals

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 at the same rate as ordinary income, except that individuals 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.

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. The deduction resulted in a maximum effective tax rate of 20 percent on such gains.

Capital losses are generally deductible in full against capital gains. In addition, individuals 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, individuals were required to use two dollars of long-term capital loss to offset each dollar of ordinary income.

Description of Provision

The provision would allow individuals a deduction equal to 50 percent of net capital gain for the taxable year. The provision 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.

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

The provision 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.

Collectibles would be excluded from net capital gain. However, an individual could elect to apply a maximum rate of 28 percent to the net capital gain attributable to collectibles, if the individual foregoes the benefit of indexing the basis of the collectible.

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. 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 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-through 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.

A taxpayer holding small business stock on the date of enactment would be able to elect, within one year from the date of enactment, to have the provision of present law (rather than this provision) apply to any gain from the sale of the stock.

The capital loss rule would not apply to losses arising in taxable years beginning before January 1, 1996.

2. Indexing of basis of certain assets for purposes of determining gain

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 Provision

In general

The provision 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 (but not loss) upon a sale or other disposition of such assets.

The provision would apply to assets acquired after December 31, 1994, held by taxpayers other than C corporations. Assets held by individuals, trusts, estates, S corporations, regulated investment companies ("RICs"), real estate investment trusts ("REITS"), and partnerships would be eligible for indexing, to the extent gain is taken into account by taxpayers other than C corporations.

Indexed assets

Assets the basis of which would be eligible for the inflation adjustment generally would include common stock of C corporations and tangible property that are capital assets or property used in a trade or business and are held by the taxpayer for more than three years. No property using neutral cost recovery would be an indexed asset.

Computation of inflation adjustment

The inflation adjustment under the provision would be computed by multiplying the taxpayer's adjusted basis in the indexed asset by the percentage by which the GDP deflator for the last calendar quarter ending before the disposition exceeds the GDP deflator for the last calendar quarter ending before the asset was acquired by the taxpayer. The inflation adjustment would be rounded to the nearest one-tenth of a percent. No adjustment would be made if the inflation adjustment is one or less.

Special entities

RICs and REITs

In the case of shares held in a RIC or REIT, partial indexing would be provided based on the

ratio of the value of indexed assets held by the entity to its total assets. This ratio would be determined every quarter (based on a three-month average). If the ratio of indexed assets to total assets exceeds 80 percent in any quarter, full indexing of the shares would be allowed for that quarter. If less than 20 percent of the assets are indexed assets in any quarter, no indexing would be allowed for that quarter for the shares. Partnership interests held by a RIC or REIT would be subject to a look-through test for purposes of determining whether, and to what degree, the shares in the RIC or REIT could be indexed.

A return of capital distribution by a RIC or REIT would be treated by a shareholder as allocable to stock acquired by the shareholder in the order in which the stock was acquired.

Partnership and S corporations, etc.

Under the provision, stock in an S corporation or an interest in a partnership or common trust fund would not be an indexed asset. Instead, the individual owner would receive the benefit of the indexing adjustment when the corporation, partnership, or common trust fund disposes of indexed assets. Under the provision, 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. If a partnership has a section 754 election in effect, a partner transferring his interest in the partnership would be entitled to any indexing adjustment that has accrued at the partnership level with respect to the partner and the transferee partner would be entitled to the benefits of indexing for inflation occurring after the transfer.

The indexing adjustment would be disregarded in determining any loss on the sale of an interest in a partnership, S corporation or common trust fund.

Foreign corporations

Common stock of a foreign corporation generally would be an indexed asset only if the stock is regularly traded on an established securities market. Indexed assets, however, would not include stock in 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 common stock in a foreign corporation would be treated as common stock in the foreign corporation and, therefore, the basis in an ADR for common stock generally would be indexed.

Other rules

Improvements and contributions to capital

No indexing would be provided for improvements or contributions to capital if the aggregate amount during the taxable year with respect to the property or stock is less than $1,000. If the aggregate amount of such improvements or contributions to capital is $1,000 or more, each addition

would be treated as a separate asset acquired at the close of the taxable year.

Suspension of holding period

No indexing adjustments would be allowed during any period during which there is a substantial diminution of the taxpayer's risk of loss from holding the indexed asset by reason of any transaction that the taxpayer, or a related party, entered into.

Short sales

In the case of a short sale of an indexed asset with a short sale period in excess of three years, the provision 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.

Related parties

The provision would not index the basis of property for sales or dispositions between related persons, except to the extent the basis of property in the hands of the transferee is a substitute basis (e.g., gifts).

Collapsible corporations

Under the provision, 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 property acquired after December 31, 1994. A taxpayer holding any indexed asset on January 1, 1995, may elect to treat the indexed asset as having been sold on such date for an amount equal to its fair market value, and as having been reacquired for an amount equal to such value. If the election is made, the asset would be eligible for indexing under the provision. Any gain resulting from the election is treated as received on the date of the deemed sale, and any loss is not allowed. The adjusted basis of a principal residence that is held and used by an individual on January 1, 1995 is subject to the indexing provision as of such date.

3. 25-percent corporate alternative tax for capital gains

Present Law

Under present law, the net capital gain of a corporation is taxed at the same rate as ordinary income, and subject to tax at graduated rates up to 35 percent. Prior to the Tax Reform Act of 1986, the net capital gain of a corporation was subject to a maximum effective tax rate of 28 percent (and the highest rate was 46 percent for ordinary income).

Description of Provision

The provision would provide an alternative tax of 25 percent on the net capital gain of a corporation if that rate is less than the corporation's regular tax rate.

Effective Date

The provision generally would apply to taxable years ending after December 31, 1994. For taxable years ending after December 31, 1994, and beginning before January 1, 1996, the 25- percent rate would apply to the lesser of (1) the net capital gain for the taxable year or (2) the net capital gain taking into account only gain or loss properly taken into account for the portion of the taxable year after December 31, 1994. The pass-through entity rules that apply to the capital gain deduction for individuals would also apply for corporations.

4. Capital loss deduction allowed with respect to the sale or exchange of a principal residence

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 Provision

The provision 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. Cost Recovery Provisions

1. Neutral cost recovery

Present Law

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, 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) and is depreciated over such periods. 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 available under 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.

Description of Provision

For MACRS property placed in service after December 31, 1994, the provision 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.

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

First, NCRS generally would follow MACRS but would replace the 200-percent declining balance method of MACRS applicable to shorter-lived property 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 taxable year is first determined by dividing (1) the gross domestic product deflator for the taxable year by (2) the gross domestic product deflator for the year the property was placed in service by the taxpayer. This ratio is then multiplied by the number equal to 1.035 raised to the nth power, where "n" is the number of full years since the property was placed in service by the taxpayer. 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 taxable year is determined by dividing (1) the gross domestic product deflator for the taxable year by (2) the gross domestic product deflator for the year the property was placed in service by the taxpayer.

The gross domestic product deflator for any taxable year is the price deflator released by the Department of Commerce for the gross domestic product for the calendar quarter that includes the mid-point of the taxpayer's taxable year. Thus, for example, the gross domestic product deflator for a taxpayer with a fiscal year ending November 30 is the deflator published for the calendar quarter ending June 30.[8] The appropriate deflator for any calendar quarter would be the last deflator for such quarter released by the Department of Commerce before the end of the next calendar quarter.

For any property, the applicable neutral cost recovery ratio may not be less than one and is rounded to the nearest one-thousandth.

The depreciation allowances provided under NCRS for regular tax purposes also would be applied for alternative minimum tax purposes (including for purposes of the adjusted current earnings component 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) determining the adjusted basis of depreciable property,[9] any interest in

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[8] The Secretary of the Treasury would be authorized to provide such rules as are necessary to determine the appropriate deflator for any taxable year that is a short year.

[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.

a pass-through entity (as defined in proposed sec. 1201(d)(2)), or the stock of a consolidated subsidiary; (2) determining earnings and profits; or (3) the recapture provisions of sections 1245 and 1250. The additional deductions determined under NCRS would be subject to the built-in loss rules of section 382. Finally, the additional deductions determined under NCRS would not be subject to the at-risk rules to the extent the taxpayer's underlying MACRS depreciation deductions are not subject to the at-risk rules.

NCRS would not apply to any property for which the taxpayer so elects[10] 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.

[10] Any election, once made, would be irrevocable.

2. Treatment of leasehold improvements

Present Law

Depreciation of leasehold improvements

Improvements made on leased property are depreciated under the modified Accelerated Cost Recovery System ("MACRS"), even if the MACRS recovery period assigned to the property is longer than the term of the lease (sec. 168(i)(8)).[11] This rule applies regardless whether the lessor or lessee places the leasehold improvements in service.[12] If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service (secs. 168(b)(3), (c)(1), (d)(2), and (i)(6)).[13]

Treatment of dispositions of leasehold improvements

A taxpayer generally recovers the adjusted basis of property for purposes of determining gain or loss upon the disposition of the property. Upon the termination of a lease, the adjusted basis of leasehold improvements that were made, but are not retained, by a lessee are taken into account to compute gain or loss by the lessee.[14] The proper treatment of the adjusted basis of improvements

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[11] Prior to the adoption of the Accelerated Cost Recovery System ("ACRS") by the Economic Recovery Act of 1981, taxpayers were allowed to depreciate the various components of a building as separate assets with separate useful lives. The use of component depreciation was repealed upon the adoption of ACRS. The denial of component depreciation also applies under MACRS, as provided by the Tax Reform Act of 1986.

[12] Former Code sections 168(f)(6) and 178 provided that in certain circumstances, a lessee could recover the cost of leasehold improvements made over the remaining term of the lease. These provisions were repealed by the Tax Reform Act of 1986.

[13] If the improvement is characterized as tangible personal property, ACRS depreciation is calculated using the shorter recovery periods and accelerated methods applicable to such property. The determination of whether certain improvements are characterized as tangible personal property or as nonresidential real property often depends on whether or not the improvements constitute a "structural component" of a building (as defined by Treas. Reg. sec. 1.48-1(e)(1)). See, for example, Metro National Corp., 52 TCM 1440 (1987); King Radio Corp., 486 F.2d 1091 (10th Cir., 1973); Mallinckrodt, Inc., 778 F.2d 402 (8th Cir., 1985) (with respect various leasehold improvements).

[14] See, Report of the Committee on Ways and Means on H.R. 3838 (H. Rept. 99-426), p. 158, and Senate Finance Committee Report on H.R. 3838 (S. Rept. 99-313), p. 105 (Tax Reform Act of 1986, 99th Cong.).

made by a lessor upon termination of a lease is less clear. Proposed Treasury regulation section 1.168-2(e)(1) provides that the unadjusted basis of a building's structural components must be recovered as whole. In addition, proposed Treasury regulation sections 1.168-2(l)(1) and 1.168-6(b) provide that "disposition" does not include the retirement of a structural component of real property if there is no disposition of the underlying building.[15] Thus, it appears that it is the position of the Internal Revenue Service that leasehold improvements made by a lessor that constitute structural components of a building must be continued to be depreciated in the same manner as the underlying real property, even if such improvements are retired at the end of the lease term.[16] Some lessors, on the other hand, may be taking the position that a leasehold improvement is a property separate and distinct from the underlying building and that an abandonment loss under section 165 is allowable at the end of the lease term for the adjusted basis of the property. In addition, lessors may argue that even if a leasehold improvement constitutes a structural component of a building, proposed Treasury regulation section 1.168-2(l)(1) (that seemingly denies the deduction at the end of the lease term) applies only to retirements, but not abandonments or demolitions, of such property.[17] Thus, it appears that some lessors take the position that, at least in certain circumstances, the adjusted basis of leasehold improvements may be recovered at the end of the term of the lease to which the improvements relate even if there is no disposition of the underlying building.

Description of Provision

The provision would conform the treatment of lessors and lessees with respect to leasehold improvements disposed of at the end of a term of lease. Thus, under the provision, a lessor that disposes of a leasehold improvement at the end of the term of a lease would be allowed to recover the adjusted basis of the improvement at that time.

Effective Date

The provision would be effective for leasehold improvements disposed of after March 13, 1995. No inference is intended as to the proper treatment of such dispositions before March 14, 1995.

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[15] For example, if a taxpayer places a new roof on building subject to ACRS, the taxpayer must continue to depreciate the allocable cost of the old roof as part of the cost of the underlying building. (Prop. Treas. reg. sec. 1.168-6(b)(1)) See, also, Joint Committee on Taxation, General Explanation of the Economic Recovery Tax Act of 1981 (97th Cong.), p. 86.

[16] See, IRS General Information Letter, dated Sept. 17, 1992.

[17] Compare the second and fourth sentences of proposed Treasury regulation section 1.168-2(l)(1).

C. Alternative Minimum Tax

Present Law

In general

Present law imposes a minimum tax on an individual or a corporation to the extent the taxpayer's minimum tax liability exceeds its regular tax liability. The individual minimum tax is imposed at rates of 26 and 28 percent on alternative minimum taxable income in excess of a phased-out exemption amount; the corporate minimum tax is imposed at a rate of 20 percent on alternative minimum taxable income in excess of a phased-out $40,000 exemption amount. Alternative minimum taxable income ("AMTI") is the taxpayer's taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items. In the case of a corporation, in addition to the regular set of adjustments and preferences, there is a second set of adjustments known as the "adjusted current earnings" adjustment.

Preference items in computing AMTI

The minimum tax preference items are:

(1) The excess of the deduction for percentage depletion over the adjusted basis of the property at the end of the taxable year. For taxable years beginning after 1992, this preference does not apply to percentage depletion allowed with respect to oil and gas properties.

(2) The amount by which excess intangible drilling costs arising in the taxable year exceed 65 percent of the net income from oil, gas, and geothermal properties. For taxable years beginning after 1992, this preference does not apply to independent producers to the extent the producer's AMTI is reduced by 40 percent or less by ignoring the preference.

(3) The amount that a financial institution's bad debt deduction determined under section 593 exceeds the amount that would have determined based on the institution's actual experience.

(4) Tax-exempt interest income on private activity bonds (other than qualified 501(c)(3) bonds) issued after August 7, 1986.

(5) Accelerated depreciation or amortization on certain property placed in service before January 1, 1987.

(6) One-half of the amount excluded from income under section 1202 (relating to gains on the sale of certain small business stock).

In addition, losses from any tax shelter farm or passive activities are denied.[18]

Adjustments in computing AMTI

The adjustments that all taxpayers must make are:

(1) Depreciation on property placed in service after 1986 must be computed by using the generally longer class lives prescribed by the alternative depreciation system of section 168(g) and either (a) the straight-line method in the case of property subject to the straight-line method under the regular tax or (b) the 150-percent declining balance method in the case of other property.

(2) Mining exploration and development costs must be capitalized and amortized over a 10-year period.

(3) Taxable income from a long-term contract (other than a home construction contract) must be computed using the percentage of completion method of accounting.

(4) The amortization deduction allowed for pollution control facilities (generally determined using 60-month amortization for a portion of the cost of the facility under the regular tax) must be calculated under the alternative depreciation system.

(5) Dealers in property (other than certain dealers of timeshares and residential lots) may not use the installment method of accounting.

The adjustments applicable to individuals are:

(1) Miscellaneous itemized deductions;

(2) State, local, and foreign real property taxes; State and local personal property taxes; and State, local, and foreign income, war profits, and excess profits taxes;

(3) Medical expenses except to the extent in excess of ten percent of the taxpayer's adjusted gross income;

(4) Standard deductions and personal exemptions;

(5) The amount allowable as a deduction for circulation expenditures must be capitalized and amortized over a 3-year period;

(6) The amount allowable as a deduction for research and experimental expenditures must be

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[18] Given the passage of section 469 (relating to the deductibility of losses from passive activities), these provisions are largely deadwood.

capitalized and amortized over a 10-year period[19]; and

(7) The special rules relating to incentive stock options.

The adjustments applicable to corporations are:

(1) The special rules applicable to Merchant Marine capital construction funds;

(2) The special deduction allowable under section 833(b) (relating to Blue Cross and Blue Shield organizations); and

(3) The adjusted current earnings adjustment.

Adjusted current earnings (ACE) adjustment

The adjusted current earnings adjustment is the amount equal to 75 percent of the amount by which the adjusted current earnings (ACE) of a corporation exceeds its AMTI (determined without the ACE adjustment and the alternative tax net operating loss deduction).[20] In determining ACE, the following rules apply:

(1) For property placed in service before 1994, depreciation generally is determined using the straight-line method and the class life determined under the alternative depreciation system.[21]

(2) Any amount that is excluded from gross income under the regular tax but is included for purposes of determining earnings and profits is included in determining ACE.[22]

(3) The inside build-up of a life insurance contract is includible in ACE (and the related premiums are deductible).

(4) Intangible drilling costs (other than those incurred by an independent producer after 1992)

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[19] No adjustment is required if the taxpayer materially participates in the activity that relates to the research and experimental expenditures.

[20] If ACE is less than AMTI, the ACE adjustment may reduce AMTI to the extent of prior-year ACE inclusions.

[21] No ACE adjustment is required for property placed in service after 1993.

[22] Exceptions and special rules are provided for related expenses that are not deductible for regular tax purposes but reduce earnings and profits, the dividends received deduction relating to certain dividends, taxes on dividends from 936 companies, and certain dividends received by certain cooperatives.

must be capitalized and amortized over a 60-month period.

(5) The regular tax rules of sections 173 (relating to circulation expenditures) and 248 (relating to organizational expenditures) do not apply.

(6) Inventory must be calculated using the FIFO, rather LIFO, method.

(7) The installment sales method generally may not be used.

(8) No loss may be recognized on the exchange of any pool of debt obligations for another pool of debt obligations having substantially the same effective interest rates and maturities.

(9) Depletion (other than depletion claimed by an independent producer after 1992) must be calculated using the cost, rather than the percentage, method.

(10) In certain cases, the assets of a corporation that has undergone an ownership change must be stepped-down to their fair market values.

Other rules

The combination of the taxpayer's net operating loss carryover and foreign tax credits cannot reduce the taxpayer's alternative minimum tax liability by more than 90 percent of the amount determined without these items.

The various credits allowed under the regular tax generally are not allowed against the alternative minimum tax.

If a taxpayer is subject to alternative minimum tax in one year, such amount of tax is allowed as a credit in a subsequent taxable year to the extent the taxpayer's regular tax liability exceeds its tentative minimum tax in such subsequent year. If the taxpayer is an individual, this credit is allowed to the extent the taxpayer's alternative minimum tax liability is a result of adjustments that are timing in nature.

Description of Provision

Repeal of the corporate alternative minimum tax

The provision would repeal the corporate alternative minimum tax for taxable years beginning after December 31, 2000. The individual alternative minimum tax, as amended by the provision, would remain in existence. In addition, as described below, the provision would make certain changes to the corporate and individual alternative minimum taxes for taxable years beginning before January 1, 2001.

Preference items in computing AMTI

The provision would make the following changes to the minimum tax preference items:

(1) The preference relating to depletion would be repealed for depletion claimed in taxable years beginning after December 31, 1995.

(2) The preference relating to intangible drilling costs would be repealed for costs incurred in taxable years beginning after December 31, 1995.

(3) The preference relating to bad debt losses of financial institutions would be repealed for taxable years beginning after December 31, 1995.

(4) In the case of a corporation, the preference relating to tax-exempt interest on private activity bonds would be repealed for interest accruing after December 31, 1995.

In addition, the special rules relating to tax shelter farm activity and passive losses would be repealed for taxable years beginning after December 31, 1995.

Adjustments in computing AMTI

The provision would make the following changes to the adjustments used in computing AMTI:

(1) The adjustment relating to depreciation would be repealed for property placed in service after March 13, 1995. Under another proposed provision, property to which the proposed neutral cost recovery system applies would not be subject to the alternative minimum tax depreciation adjustment. The neutral cost recovery system generally would apply to qualified property placed in service after December 31, 1994, unless the taxpayer irrevocably elects, on a property-by-property basis, to not have the system apply.

(2) The adjustment relating to mining exploration and development costs would be repealed for costs paid or incurred after December 31, 1995.

(3) The adjustment relating to long-term contracts would be repealed for contracts entered into after December 31, 1995.

(4) The adjustment relating to pollution control facilities would be repealed for property placed in service after December 31, 1995.

(5) The adjustment relating to installment sales would be repealed for dispositions after December 31, 1995.

(6) The adjustments relating to circulation and research and experimental expenditures would be repealed for costs paid or incurred after December 31, 1995.

(7) The adjustment relating to Merchant Marine capital construction funds would be repealed for deposits made to a fund after December 31, 1995, and to earnings received or accrued after December 31, 1995, on amounts in such funds. Withdrawals of deposits and earnings from a fund after December 31, 1995, would be treated as allocable: (a) first to deposits (and earnings received or accrued) before January 1, 1987; (b) then, to deposits (and earnings received or accrued) after December 31, 1986, and before January 1, 1996; and (c) then, to deposits (and earnings received or accrued) after December 31, 1995.

(8) The denial of the special deduction allowed under section 833(b) would be repealed for taxable years beginning after December 31, 1995.

<u>**Adjusted current earnings (ACE) adjustment**</u>

The provision would make the following changes to the ACE adjustment of the corporate alternative minimum tax:

(1) The ACE rules relating to the inclusion (or deduction) of items included (or excluded) from the calculation of earnings and profits would not apply to taxable years beginning after December 31, 1995.

(2) The ACE adjustment relating to intangible drilling costs would be repealed for amounts paid or incurred after December 31, 1995.

(3) The ACE adjustment relating to section 173 and 248 costs would be repealed for amounts paid or incurred after December 31, 1995.

(4) The ACE adjustment relating to LIFO inventory would be repealed for LIFO adjustments arising in taxable years beginning after December 31, 1995.

(5) The ACE adjustment relating to installment sales would be repealed for sales after December 31, 1995.

(6) The ACE adjustment relating to the exchange of debt pools would be repealed for exchanges after December 31, 1995.

(7) The ACE adjustment relating to built-in losses with respect to certain changes of ownership would be repealed for ownership changes after December 31, 1995.

(8) The ACE adjustments relating to section 173 and 248 costs would be repealed for amounts paid or incurred after December 31, 1995.

(9) The ACE adjustment relating to depletion would be repealed for depletion allowed in taxable years beginning after December 31, 1995.

Use of credits

The special rules relating to the use of net operating losses and foreign tax credits would be repealed for net operating losses and foreign tax credits used in taxable years beginning after December 31, 1995. Carrybacks of losses and credits to taxable years beginning before January 1, 1996, would continue to be subject to the 90 percent limitations.

The provision would not change the rules regarding the availability of other credits against the alternative minimum tax.

For taxable years beginning after December 31, 1995, a taxpayer with alterative minimum tax credit carryovers would be allowed to use these credits to offset 90 percent of its regular tax liability (determined after the application of other credits). As under present law, in no event could alternative minimum tax credit carryovers be used to reduce the taxpayer's tax liability below its tentative minimum tax, if any.

Effective Date

Except as provided above, the provision would be effective for taxable years beginning after December 31, 1995.

D. Public Debt Reduction Checkoff and Trust Fund

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.[23] 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.[24]

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 Provision

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

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[23] Prior to enactment of the Revenue Reconciliation Act of 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.

[24] 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.

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.

Under the provision, amounts earmarked by taxpayers to reduce the public debt would be transferred into a Public Debt Reduction Trust Fund, which would be used only to retire or purchase Federal securities (other than obligations held by the Social Security Trust Fund, the Civil Service Retirement and Disability Fund, and the Department of Defense Military Retirement Fund). Related provisions (outside the jurisdiction of the committee and, thus, not included in the provision) would require either specific spending cuts or an across-the-board sequestration in Federal spending (with certain exceptions) to match the amounts designated by taxpayers for debt reduction.

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.

E. Small Business Incentives

1. Increase in unified estate and gift tax credits

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.[25] 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 during his lifetime or at death 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 five-percent surtax imposed upon cumulative taxable transfers over $10 million and not exceeding $21,040,000.[26]

The unified credit originally was 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

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[25] Prior to 1976, separate tax rate schedules applied to the gift tax and the estate tax.

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

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.

Annual exclusion for gifts

A taxpayer may exclude $10,000 of gifts made to any one donee during a calendar year. This annual exclusion does not apply to gifts of future interests (e.g., reversions or remainders). Prior to 1982, the annual exclusion was $3,000.

Special use valuation

Generally, for Federal transfer tax purposes, the value of property is its fair market value, i.e., the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. Under Code section 2032A, an executor may elect for estate tax purposes to value certain "qualified real property" used in farming or another qualifying closely-held trade or business at its current use value, rather than its highest and best use value. Presently, the maximum reduction in the value of such real property resulting from an election under Code section 2032A is $750,000.

Generation-skipping transfer tax

A generation-skipping transfer tax (GST tax) generally is imposed on transfers, either directly or through a trust or similar arrangement, to a "skip person" (i.e., a beneficiary in a generation more than one generation below that of the transferor). Transfers subject to the GST tax include direct skips, taxable terminations and taxable distributions.[27]

A person is allowed an exemption from the GST tax of up to $1,000,000 for generation-skipping transfers made during life or at death.

Installment payment of estate tax

Under Code section 6166, an executor generally may elect to pay the Federal estate tax attributable to an interest in a closely held business in installments over, at most, a 14-year period. To qualify for the election, the business must be an active trade or business and the value of the decedent's interest in the closely held business must exceed 35 percent of the decedent's adjusted

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[27] For this purpose, a direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person (e.g., a gift from grandparent to grandchild). A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person. A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or a direct skip).

gross estate.

If an election is made, the estate pays only interest for the first four years, followed by up to ten annual installments of principal and interest. Interest is generally imposed at the rate applicable to underpayments of tax under Code section 6621 (i.e., the Federal short term rate plus three percentage points). Under Code section 6601(j), however, a special four-percent interest rate applies to the amount of deferred estate tax attributable to the first $1,000,000 in value of the closely-held business. The maximum amount that may be subject to the four-percent rate is the lower of (1) $345,800 (i.e., the amount of estate tax on the first $1,000,000), less the amount of allowable unified credit, or (2) the amount of estate tax attributable to the closely-held business that is being paid in installments pursuant to Code section 6166.

Description of Provision

The provision would 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). 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. The indexed exclusion amount would be rounded to the nearest $10,000.

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

In addition to increasing and indexing the unified credit, the provision would index the following amounts for inflation beginning after 1998: (1) the $10,000 annual exclusion for gifts; (2) the $750,000 ceiling amount on special use valuation under Code section 2032A; (3) the $1,000,000 generation-skipping transfer tax exemption; and (4) the value of a closely-held business (i.e., $1,000,000) eligible for the special four-percent interest rate under Code section 6601(j). Indexing of the annual exclusion would be rounded to the nearest $1,000 and indexing of the other amounts would be rounded to the nearest $10,000.

Effective Date

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

2. Increase in expensing for small businesses

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).[28] 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).

Description of Provision

The provision would increase the $17,500 amount allowed to be expensed under Code section 179 to $35,000. The increase would be phased in as follows:

Maximum Expensing	Taxable Year
$22,500	1996
$27,500	1997
$32,500	1998
$35,000	1999

Effective Date

The provision would be effective for property placed in service in taxable years beginning after December 31, 1995, subject to the phase-in schedule set forth above.

[28] The amount permitted to be expensed under Code section 179 is increased by up to $20,000 for certain property placed in service by a business located in an empowerment zone (sec. 1397A).

3. Clarification of definition of principal place of business; Treatment of storage of product samples

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)).[29] These rules apply to houses, apartments, condominiums, mobile homes, boats, and other similar property (sec. 280A(f)(1)). Under Internal Revenue Service (IRS) rulings, the deductibility of expenses incurred for local transportation between a taxpayer's home and a work location sometimes depends on whether the taxpayer's home office qualifies under section 280A(c)(1) as a principal place of business (see Rev. Rul. 94-47, 1994-29 I.R.B. 6).

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 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."[30]

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[29] If an employer provides access to suitable space on the employer's premises for the conduct by an employee of particular duties, then, if the employee opts to conduct such duties at home as a matter of personal preference, the employee's use of the home office is not "for the convenience of the employer." See, e.g., W. Michael Mathes, (1990) T.C. Memo 1990-483.

[30] 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.

Because the taxpayer did not meet 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.

Home office 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)).

Description of Provision

The provision 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 used by the taxpayer to conduct administrative or management activities for a trade or business and (2) there is no other fixed location of the trade or business where the taxpayer conducts substantial administrative or management activities. As under present law, deductions would be allowed for a home office meeting the above two-part test only if the office is exclusively used on a regular basis 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.

Thus, under the provision, a home office deduction would be allowed (subject to the present-law "convenience of the employer" rule governing employees) if a portion of a taxpayer's home is exclusively and regularly used to conduct administrative or management activities for a trade or business of the taxpayer, who does not conduct substantial administrative or management activities at any other fixed location of the trade or business, regardless of whether administrative or management activities connected with his trade or business (e.g., billing activities) are performed by others at other locations. The fact that a taxpayer also carried out administrative or management activities at sites that were not fixed locations of the business, such as a car or hotel room, would not affect the taxpayer's ability to claim a home office deduction. Moreover, if a taxpayer conducts some administrative or management activities at a fixed location of the business outside the home, the taxpayer still would be eligible to claim a deduction so long as the administrative or management activities conducted at any fixed location of the business outside the home were not substantial (e.g., the taxpayer occasionally does minimal paperwork at another fixed location of the business). In addition, a taxpayer's eligibility to claim a home office deduction under the provision would not be affected by the fact that the taxpayer conducts substantial non-administrative or non-management business activities at a fixed location of the business outside the home.

In addition, the provision would clarify that the special rule contained in present-law section 280A(c)(2) permits deductions for expenses related to a storage unit 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.

Effective Date

The provision would apply to taxable years beginning after 1995.

IV. FAMILY REINFORCEMENT TAX ACT (TITLE IV)

A. Tax Credit for Adoption Expenses

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 Provision

The provision would provide taxpayers with a maximum nonrefundable 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, and the principal purpose of which, are the legal adoption of an eligible child. An eligible child would be an individual: (1) who has not attained age 18 on the date the adoption becomes final, or (2) who is physically or mentally incapable of caring for himself or herself. No credit would be allowed for expenses incurred in 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. For purposes of this AGI test, the taxpayer's AGI would be increased by the amount otherwise excluded from gross income under Code sections 911, 931. or 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands, and residents of Puerto Rico, respectively).

To avoid a double benefit, the provision 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. Also, the credit would not be allowed for any expenses for which a grant is received under any Federal, State, or local program except in the case of special needs children. The provision 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 of the

taxable year and (2) furnished over one-half of the cost of maintaining that household in that taxable year. Finally, the provision 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. Nonrefundable Credit for Custodial Care of Certain Elderly Family Members in Taxpayer's Home

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 household, and $172,050 for married couples filing joint returns.

Description of Provision

The provision would provide taxpayers who maintain a household including one or more "qualified persons" with a maximum nonrefundable 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 the father or mother of: (a) the taxpayer, (b) the taxpayer's spouse or (c) a former spouse of the taxpayer. A stepfather, stepmother and ancestors of the father or mother would be treated as a father or mother for these purposes.

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

An individual would satisfy the disability test if the individual is physically or mentally incapable of caring for himself or herself.

The provision would provide that an individual would be treated as maintaining a household for any period only if over one-half of 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 provision 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 of the taxable year and (2) furnished over one-half of the cost of maintaining that household in that taxable year. Finally, the provision 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.

V. INCREASE IN THE SOCIAL SECURITY EARNINGS LIMIT (TITLE V)

Present Law

Under present law, senior citizens age 70 and older receive full Social Security benefits regardless of the amount of earnings they have from wages or self employment. Senior citizens between age 65 and 69 are eligible for full benefits only if their earnings are lower than the earnings limit amount determined by law. In 1995, the annual earnings limit for those age 65 to 69 is $11,280. The earnings limit amount is indexed and increases annually in proportion to the rate of average wage growth in the economy.

Senior citizens age 65 to 69 who earn more than the earnings limit lose $1 in Social Security benefits for every $3 in wages or self employment income they earn over the limit.

Description of Provision

The provision would gradually raise the earnings limit for those age 65 to 69 to $30,000 by the year 2000. The increase would be phased in over 5 years as follows:

Year	Proposed earnings limit
1996	$15,000
1997	$19,000
1998	$23,000
1999	$27,000
2000	$30,000

Senior citizens age 65 to 69 who earn over the given earnings limit for the year would continue to lose $1 in benefits for every $3 earned over the limit.

Effective Date

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

VI. THE TAX TECHNICAL CORRECTIONS ACT OF 1995 (TITLE VI)

Description of Provision

The provision would incorporate (with modifications) the "Tax Technical Corrections Act of 1995," previously introduced separately as H.R. 1121 by Chairman Archer and Mr. Gibbons on March 3, 1995. The provisions of this legislation are described in detail in the Joint Committee on Taxation pamphlet, *Explanation of the Tax Technical Corrections Act of 1995 (H.R. 1121)* (JCS-6-95), March 8, 1995.

H.R. 1121 would be modified, for purposes of this provision, by dropping two provisions ((1) section 2(a)(3) (relating to correction of head of household rate table for proper indexation) and (2) section 3(f)(1) (relating to treatment of certain nonqualified withdrawals from Merchant Marine capital construction funds)), and by adding new clerical corrections.