[JOINT COMMITTEE PRINT]

DESCRIPTION OF POSSIBLE OPTIONS TO INCREASE REVENUES PREPARED FOR THE COMMITTEE ON WAYS AND MEANS

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

WITH THE STAFF

OF THE

COMMITTEE ON WAYS AND MEANS

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation in conjunction with the staff of the House Committee on Ways and Means, provides a brief description of various possible options to increase revenues.

The pamphlet was prepared at the request of Committee on Ways and Means Chairman Rostenkowski for the use of the Committee on Ways and Means in its consideration of revenue proposals in connection with the fiscal year 1988 Budget Resolution. Committee hearings have been scheduled for July 7, 8, and 9, 1987, on options for achieving the revenue reconciliation targets under the fiscal year 1988 Budget Resolution. These hearings will not include further testimony on either the particular Administration fiscal year 1988 budget proposals or any other proposals on which the Committee (or its subcommittees) have already held hearings.

The first part of the pamphlet describes the revenue proposals contained in the President's Fiscal Year 1988 Budget (submitted to Congress on January 5, 1987). The second part of the pamphlet describes certain other possible revenue options. For each item, there is a summary description of present law, the President's budget proposal (where applicable), possible proposals, arguments for and against the proposals, and estimated revenue effects (if available by the publication date). The third part provides a table of the estimated revenue effects of the proposals included in parts one and two (if available).

The revenue options in this pamphlet are not proposals or recommendations of the staff of the Joint Committee on Taxation or of the staff of the Committee on Ways and Means, but rather options that the Committee on Ways and Means may wish to consider in connection with legislation relating to revenue reconciliation targets under the fiscal year 1988 Budget Resolution. The possible proposals described in the pamphlet include those submitted by Members of the Committee at the request of Chairman Rostenkowski.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of Possible Options to Increase Revenues Prepared for the Committee on Ways and Means* (JCS-17-87), June 25, 1987.

I. REVENUE AREAS ADDRESSED BY THE PRESIDENT'S 1988 BUDGET PROPOSALS

A. Employment Tax Provisions

1. Extend Medicare Payroll Tax to All State and Local Government Employees

Present Law

Before enactment of the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) (P.L. 99-272), State and local government employees were covered for social security and Medicare benefits only if the State and the Secretary of Health and Human Services (HHS) entered into a voluntary agreement providing such coverage. In COBRA, the Congress extended Medicare coverage (and the corresponding hospital insurance payroll tax) on a mandatory basis to State and local government employees hired after March 31, 1986, for services performed after that date. Under present law, State and local government employees hired before April 1, 1986, still are not covered for Medicare unless a voluntary agreement is in effect. Currently, 70 percent of all State and local government employees are covered under a voluntary agreement. Medicare coverage (and the hospital insurance payroll tax) is mandatory for Federal employees.

For wages paid in 1987 to Medicare-covered employees, the total hospital insurance tax rate is 2.9 percent of the first $43,800 of wages; the tax is divided equally between the employer and the employee.

President's Budget Proposal

The President's budget proposal would extend Medicare coverage on a mandatory basis to all employees of State and local governments not otherwise covered under present law, without regard to their dates of hire. These employees and their employers would become liable for the hospital insurance portion of the tax under the Federal Insurance Contributions Act (FICA) and the employees would earn credit toward Medicare eligibility based on their covered earnings.

This proposal would be effective January 1, 1988.

Pros and Cons

Arguments for the proposal

1. The current population survey conducted by the Bureau of the Census using March 1985 survey data found that 94 percent of individuals age 65 or older who reported receipt of a State or local government pension were eligible for Medicare. This is attributable to

the fact that many State and local government employees who were not subject to the hospital insurance portion of the FICA tax are entitled to receive Medicare coverage due to other employment or spousal Medicare eligibility. Thus, it is only fair that State and local government employees hired before April 1, 1986, pay the hospital insurance portion of the FICA tax, just as Federal government employees, State and local government employees hired after March 31, 1986, and private sector employees do.

2. The benefits of Medicare coverage should be extended to all employees of State and local governments.

Arguments against the proposal

1. Requiring State and local governments to pay the hospital insurance portion of the FICA tax for employees hired before April 1, 1986, would impose a significant cost burden on State and local governments. The COBRA legislation effectively phases in the burden of the tax.

2. State and local governments should retain the right to decide how to structure the retirement benefits of their employees hired before April 1, 1986.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Extend Medicare payroll tax to all State-local government employees	1.3	1.9	1.9	5.2

2. Expand Employer Share of FICA Tax to Include All Cash Tips

Present Law

The FICA taxes imposed on the employee and the employer generally are equal. The employer is responsible for withholding the employee's share of the tax from the employee's wages and remitting the tax, together with the employer's share of the tax, to the Internal Revenue Service. The current tax rate for both the employer and the employee is 7.15 percent of wages, consisting of 5.7 percent for Old-Age, Survivors and Disability Insurance and 1.45 percent for Medicare Hospital Insurance.

Special rules apply to tips, however. For purposes of the employee FICA tax, tips received by employees are considered remuneration for services and are subject to the tax. The tips are generally deemed to be received at the time the employee files a written statement with the employer reporting the receipt of the tips.

The full amount of tips received by an employee is not, however, usually subject to the FICA tax imposed on the employer. The employee is deemed to receive wages for purposes of the employer's share of FICA taxes only to the extent of the excess of the Federal minimum wage rate over the actual wage rate paid by the employer. Any tips received in excess of the difference between the wages paid and the minimum wage are not subject to the employer's portion of the tax.

President's Budget Proposal

Under the President's budget proposal, all cash tips would be included within the definition of wages for purposes of the employer's share of FICA taxes. Thus, employers would be required to pay FICA taxes on the total amount of cash tips up to the Social Security wage base.

This proposal would be effective January 1, 1988.

Pros and Cons

Arguments for the proposal

1. Benefits paid to employees are based on total cash tips. Employees must report and pay FICA tax on the total amount of tips received while employers must only pay FICA tax on a portion of such tips. This acts as a subsidy to the employer. In effect, tipped employees accrue a given benefit with lower contributions than any other employees covered by Social Security.

2. Implementation of this proposal would ease an administrative burden on the Social Security Administration ("SSA"). Currently, the SSA must maintain separate records of the amount of reported tips for tax accountability purposes. Each year the U.S. Treasury transfers to the Social Security trust fund the amount of FICA

taxes due on the total wages reported to the SSA during the prior year. Because no FICA taxes are paid by the employer on tips (other than the amount necessary to bring the employee's salary up to the minimum wage), the SSA must keep a separate record of tips so that it will be able to tell the Treasury Department the total amount of wages on which both employer and employee taxes are due and the total amount on which only employee taxes are due.

Arguments against the proposal

1. It is unfair to employers to tax them on amounts paid directly by customers to employees.
2. In the case of an individual who is employed by more than one employer, withholding may be applied on total wages in excess of the Social Security wage base.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
Expand employer share of FICA tax to include all cash tips.........	0.2	0.3	0.3	0.8

3. Extend FICA Tax to Inactive Duty Earnings of Military Reservists and Certain Other Earnings

Present Law

The Social Security System is financed by payroll taxes imposed under the Federal Insurance Contributions Act ("FICA"). The 1987 rates of this tax are 7.15 percent paid by employers and 7.15 percent paid by employees on wages (up to a maximum of $43,800). An employee only receives Social Security credit for his earnings if his salary constitutes wages and if his job is included in the definition of employment ("covered employment") under section 3121. The Act generally defines wages to include all remuneration for employment but provides specific exemptions.

President's Budget Proposal

The President's budget proposal would eliminate the exemption from the definition of wages for several categories of earnings. The exemption would be repealed for the following:

(a) *Armed Forces Reservists.*—Approximately 1.4 million Armed Forces reservists do not receive Social Security credit and are not subject to Social Security taxes for their inactive duty earnings, because "inactive duty training" (generally, weekend training drill sessions) has not been included as covered employment under section 3121. Earnings from full-time active duty or from "active duty for training" (training sessions lasting several weeks) constitute covered employment under current law.

(b) *Students.*—Services performed by a student under various circumstances in an academic setting are excluded from coverage under Social Security and the student's wages are not subject to FICA taxes. Such students include those employed by a school they are attending (or college club or an auxiliary nonprofit organization of a school) and student nurses employed by a hospital or nurses' training school they are attending.

(c) *Agricultural workers.*—Under present law, cash remuneration paid to an employee in any taxable year for agricultural labor is excluded from the definition of wages unless the employee receives more than $150 during the year for such labor or the employee works for the employer more than 20 days during the year.

(d) *Individuals Aged 18-21.*—Services performed by individuals under age 21 who are employed by their parents, even if employed in the parent's trade or business, do not currently constitute covered employment.

(e) *Spouses.*—Services performed by an individual in the employ of his spouse do not constitute covered employment.

These proposals would be effective January 1, 1988.

Pros and Cons

Argument for the proposal

Currently, some individuals such as Armed Forces reservists do not receive social security credit for their earnings. Elimination of these exemptions from covered employment would provide more equitable coverage of such individuals.

Argument against the proposal

The administrative burden involved in extending FICA taxes to these groups outweighs the equity in coverage of these types of earnings.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
Extend FICA tax to inactive duty earnings of military reservists and certain other earnings	0.2	0.3	0.3	0.7

4. Treatment of Group-Term Life Insurance as Wages Under FICA

Present Law

The cost of group-term life insurance provided by an employer to an employee is excluded from the definition of wages for purposes of the FICA tax. In 1987, the first $43,800 of wages is subject to a total FICA tax of 14.3 percent. One-half of this tax (7.15 percent) is paid by the employee and one-half is paid by the employer.

For income tax purposes, in general, the cost of employer-provided group-term life insurance is includible in an employee's income to the extent that the coverage exceeds $50,000. Employer-provided group-term life insurance also is included in an employee's income if the coverage is provided under a plan that fails to satisfy nondiscrimination and qualification requirements.

President's Budget Proposal

Under the Administration proposal, employer-provided group-term life insurance would be included in wages for FICA tax purposes to the extent such insurance is includible in income for income tax purposes.

This proposal would be effective January 1, 1988.

Pros and Cons

Arguments for the proposal

1. The exclusion from wages of employer-provided group-term life insurance can result in taxpayers having the same economic income paying different amounts of FICA tax because of the form in which their compensation is received. In addition, the exclusion from wages of employer-provided group-term life insurance narrows the FICA tax base, thereby requiring higher tax rates to generate a given amount of revenues.

2. The proposal would allow low- and middle-income employees to earn credit toward social security benefits by virtue of compensation received in the form of group-term life insurance.

Arguments against the proposal

1. The exclusion from wages of employer-provided group-term life insurance is justified, as a matter of social policy, by the fact that the nondiscrimination requirements for such exclusion encourage the provision by employers of group-term life insurance to low- and middle-income employees who otherwise might not purchase such insurance.

2. If the proposal were enacted, employers would be less likely to provide group-term life insurance to low- and middle-income employees. In addition, many of such employees would not purchase

life insurance on their own. Accordingly, their survivors may in some cases need public assistance, since social security survivor benefits often are inadequate. The cost of providing this assistance may well exceed the cost of retaining the present-law exclusion of employer-provided group-term life insurance from wages.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Treatment of group-term life insurance as wages under FICA	([1])	0.1	0.1	0.2

[1] Gain of less than $50 million.

5. Railroad Retirement Tax Proposals

a. Increase in railroad retirement payroll tax

Present Law

The primary source of income to the railroad retirement account is payroll taxes levied on covered employers and their employees. Currently, both employers and employees pay a Tier I tax which is equivalent to the social security tax rate. In addition, a Tier II tax is paid by both rail employers and employees. These taxes are applied to compensation paid to employees, up to a maximum annual amount. Under present law, the Tier II tax rate is 14.75 percent for employers and 4.25 percent for employees. The Tier II wage base in 1987 is $32,700.

Pursuant to the Railroad Retirement Solvency Act, the Railroad Retirement Board on June 16, 1987 submitted an actuarial report on the status of the railroad retirement system. As part of this report, the Chairman of the Board recommended a 3 percent increase in the tier 2 tax rate as of January 1, 1988. The Board's Chief Actuary submitted a recommendation to increase the tier 2 tax rate by 4.5 percent on January 1, 1988. The Actuary also suggested the establishment of a body to study the merits of a tax on operating funds to underwrite a portion of railroad retirement benefit costs. The Chief Actuary's report was not supported by the Management Member of the Board but was supported by the Labor Member who additionally suggested that the entire increase be borne by the rail employers.

President's Budget Proposal

The President's budget proposal would increase the railroad retirement Tier II taxes by 3.0 percentage points. This increase would be achieved in two steps—a 1.5 percentage point increase, effective January 1, 1988, and an additional 1.5 percentage point increase effective January 1, 1989. (The proposal does not describe how this increased tax would be apportioned between emloyers and employees.

Pros and Cons

Argument for the proposal

Additional revenues are needed to ensure the medium- and long-range solvency of the Rail Industry Pension Fund.

Argument against the proposal

Increases in the level of pension contributions by both employers and employees will present an even greater barrier to employment in an aging yet important national industry.

b. Partial rail sector financing of vested dual benefits

Present Law

Under present law, vested dual benefits are payable to retired rail workers who had the equivalent of 10 years' coverage under both railroad retirement and social security prior to 1975. These benefits, which phase out over time, are financed by general revenues.

President's Budget Proposal

The President's budget proposal would require the rail industry to finance 25 percent of the cost of vested dual benefits. This financing would be derived from the rail industry pension fund, which is funded by Tier II payroll taxes.

The proposal would include an increase in the Tier II payroll taxes to finance the cost borne by the rail industry pension fund. (This increase would be in addition to the 3.0 percent increase in Tier II taxes described above.) The proposal does not describe how the increase of Tier II taxes would be apportioned between employers and employees.

Pros and Cons

Argument for the proposal

General revenue financing of vested dual benefits amounts to a taxpayer subsidy of railroad retirees, and should be partially offset by rail sector contributions.

Argument against the proposal

Vested dual benefits are a product of non-railroad employment, rather than railroad employment and thus, should be financed by general revenues, as was originally established in 1974.

c. Extend FUTA tax to railroad employment

Present Law

Under present law, railroad employment is not covered by the Federal-State unemployment insurance system. Instead, railroad employees are covered by a separate Railroad Sickness and Unemployment Insurance Fund, which is financed by payroll taxes levied on rail employers.

The railroad unemployment insurance (RRUI) program has permanent authority to borrow from the railroad retirement program in order to pay RRUI benefits. The Railroad Retirement Solvency Act of 1983, as modified by the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA), established a loan repayment tax, beginning at 4.3 percent on July 1, 1986, and changing to 4.7 percent for 1987, 6.0 percent for 1988, 2.9 percent for 1989, and 3.2 percent for 1990. The tax expires after September 30, 1990.

COBRA further provided that an automatic surcharge of 3.5 percent on the loan repayment tax base will be levied if the RRUI program has to borrow from the retirement program. The surtax proceeds are to be used to repay such loans made after September 30, 1985, and is in effect for any year if on September 30 of the prior year any principal or interest from a loan after September 30, 1985 remains unpaid.

As mentioned above, the Railroad Retirement Board issued a report on finances on June 16, 1987. As part of this report, the Chairman of the Board recommended an extension of the special repayment tax required to retire the debts of the Railroad Unemployment and Sickness Insurance Account. Similar recommendations were made by the Chief Actuary and the Labor Member of the Board.

President's Budget Proposal

The President's budget proposal would extend coverage under the Federal-State unemployment insurance system to railroad employment. In addition, a transitional program would be developed to guarantee certain levels of benefits for rail workers who became unemployed after September 30, 1987. The Railroad Sickness and Unemployment Insurance Fund would continue to finance sickness payments and to repay the Fund's debt to the rail industry pension fund.

This proposal would be effective October 1, 1987.

Pros and Cons

Argument for the proposal

Currently, the Railroad Sickness and Unemployment Insurance Fund is experiencing financial difficulty and has required loans from the Railroad Industry Pension Fund in the past to avoid insolvency. Given these circumstances, the more financially sound Federal/State unemployment insurance system should assume coverage of railroad workers.

Argument against the proposal

The railroad industry historically has maintained separate funds for its retirees and unemployed. Levels of contributions mandated by recent legislation have moved these funds closer to financial stability and therefore integration with the Federal-State unemployment system is unnecessary.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
a. Increase in railroad retirement payroll tax	0.1	0.2	0.3	0.6
b. Partial rail sector financing of vested dual benefits	0.1	0.1	0.1	0.2
c. Extend FUTA tax to railroad employment	0.1	0.1	0.1	0.4

B. Excise Tax Provisions

1. Proposals Relating to Black Lung Benefits

a. Increase in coal excise tax

Present Law

A manufacturers excise tax is imposed on the sale or use of domestically mined coal (other than lignite) by the producer (secs. 4121, 4218). The Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) increased the rate of the tax by 10 percent, effective April 1, 1986, to $1.10 per ton of coal from underground mines, and 55 cents per ton of coal from surface mines. However, the amount of tax may not exceed 4.4 percent of the sales price.

Amounts equal to the revenues collected from the coal excise tax are appropriated automatically to the Black Lung Disability Trust Fund. The Trust Fund pays certain black lung disability benefits to coal miners (or their survivors) who have been disabled by black lung disease in cases where no coal mine operator is found specifically responsible for the individual miner's disease. Present law includes an unlimited authorization for advances, generally repayable with interest, from the general fund to the Trust Fund. However, COBRA provided a five-year moratorium on interest accruals (from September 30, 1985 to October 1, 1990) with respect to repayable advances to the Trust Fund.

Under present law, the tax will revert to 50 cents on underground coal and 25 cents on surface coal (subject to a limit of two percent of price) on the earlier of January 1, 1996, or the first January 1 as of which there is (1) no balance of repayable advances made to the Trust Fund, and (2) no unpaid interest on such advances.

President's Budget Proposal

The President's budget proposal would increase the excise tax to $1.70 per ton for coal from underground mines and $0.85 per ton for coal from surface mines, subject to a cap of 6.8 percent of the sales price. This rate would apply through 1990, with decreasing rates thereafter. In addition, the proposal would repeal the five-year moratorium on interest accruals on repayable advances to the Trust Fund.

The Administration also has proposed certain changes to slow the growth of black lung benefit payments, including a one-year freeze on cost-of-living adjustments for benefits. The Administration estimates that its excise tax and related benefit proposals would eliminate the Trust Fund deficit by the year 2007. As of the beginning of fiscal year 1987, the deficit (i.e., the amount of advances repayable to the general fund) was $2.9 billion.

Pros and Cons

Arguments for the proposal

1. The Black Lung Trust Fund should be placed on an actuarially sound basis by increasing the coal excise tax and adopting other parts of the Administration proposal. While the 10-percent increase enacted in COBRA may allow the Trust Fund to achieve operational solvency, that increase will not be sufficient to achieve retirement of the Trust Fund's indebtedness to the general fund.

2. The Administration proposal is intended to carry out the intent of the Congress that full financial responsibility for the black lung benefits program should be borne by the coal industry for post-1973 claimants. The general fund would continue to fund approximately $1 billion annually in black lung benefits to certain pre-1974 claimants.

Arguments against the proposal

1. When COBRA was enacted in 1986, the Congress carefully balanced the financial needs of the Trust Fund and the depressed state of the coal industry. The further tax increases proposed by the Administration would adversely affect the ability of U.S. coal companies to compete with foreign coal in international markets and with other fuel sources in the domestic market.

2. Since the Trust Fund deficit can be viewed as attributable to the excessively liberal eligibility requirements for benefits that applied under prior law, it would be unfair to impose additional tax increases on the coal industry to fund retroactively claim payments that were not based on adequate medical evidence establishing disability from black lung disease.

b. Inclusion of black lung cash benefits in gross income

Present Law

Title IV of the Federal Coal Mine Health and Safety Act provides for payment of monthly cash benefits to eligible coal miners who are totally disabled by black lung disease and to their survivors. Also, a coal miner receiving black lung cash benefits is eligible for related medical and rehabilitation benefits.

Under present law, black lung disability benefits are excludable from gross income as workers' compensation benefits (Rev. Rul. 72-400, 1972-2 C.B. 75).

President's Budget Proposal

Under the President's budget proposal, black lung cash benefits would be includible in the recipient's gross income. (The value of medical and rehabilitation benefits received by a disabled miner would continue to be excludable from income.) This proposal would be effective January 1, 1988.

Pros and Cons

Arguments for the proposal

1. Black lung cash benefits can be viewed essentially as wage replacement payments and therefore should be included in the recipient's gross income. For similar reasons, disability payments under employer-provided plans generally are includible in the recipient's gross income, as are all unemployment compensation benefits. The treatment of wage replacement payments in the same manner as wages or similar compensation (such as sick pay) contributes to more equal tax treatment of individuals with the same economic income.

2. Recipients of black lung benefits who are low-income individuals would receive tax relief through the increased standard deduction and personal exemption amounts and the lower tax rates enacted in the 1986 Act. This represents a more appropriate approach to providing tax relief to low-income individuals than using a special preference for one type of wage replacement payments available only to workers in one industry. The Administration proposal would continue to exclude from income the value of black-lung medical and rehabilitation benefits; this approach is consistent with the general exclusion of employer-provided health care.

Arguments against the proposal

1. Black lung benefits can be viewed as essentially similar to personal injury damages and hence should not be taxed to the recipient. This approach is consistent with the general present-law exclusions for amounts (1) received under workers' compensation acts as compensation for personal injuries or sickness, or as benefits to a survivor of a deceased employee; (2) received for personal injuries under an employer-provided accident and health plan, if determined without regard to the period of the employee's absence from work; and (3) for damage payments under tort law for personal injuries or sickness.

2. The present-law exclusion appropriately recognizes that many recipients of black lung benefits need the full amount of the payments, unreduced by taxes, to maintain a subsistence standard of living.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
a. Increase in coal excise tax	0.3	0.3	0.3	0.8
b. Inclusion of black lung cash benefits in gross income	0.1	0.2	0.2	0.5

2. Repeal of Current Gasohol, Bus, and State and Local Government Highway Excise Tax Exemptions

Present Law

Revenues from excise taxes on motor fuels, tires, and trucks and trailers, and a use tax on heavy highway vehicles are deposited in the Highway Trust Fund. Trust Fund monies are used to finance authorized expenditures from the Highway Trust Fund. These Highway Trust Fund excise taxes are scheduled to expire after September 30, 1993. Exemptions from all or part of some of these excise taxes are provided for fuels containing alcohol, for private and public bus operators, and for State and local governments.

Alcohol fuels.—An exemption of 6 cents per gallon is provided for gasohol blends (i.e., 10 percent pure alcohol) of diesel, gasoline, and special motor fuels. (The current Highway Trust Fund tax rate is 15 cents per gallon for highway diesel fuel and 9 cents per gallon for gasoline and special motor fuels.) A 6-cents-per-gallon exemption also is provided for neat methanol and ethanol fuels which contain at least 85-percent alcohol produced from a substance other than petroleum or natural gas. A 4-1/2-cents-per-gallon exemption is available for such alcohol blends produced from natural gas. These alcohol fuels exemptions are scheduled to expire after September 30, 1993.

Buses.—Private and public bus operators generally are exempt from the excise tax on tires. Intercity common carrier buses, school buses, and qualified local buses are exempt from the 9-cents-per-gallon highway taxes on gasoline and special motor fuels. School buses and qualified local buses are also exempt from the 15-cents-per-gallon diesel fuel tax. In addition, private intercity buses receive a 3-cents-per-gallon refund (or credit) of the 15-cents-per-gallon highway diesel fuel tax. No exemption is available for buses engaged in transportation that is not scheduled and is not along regular routes, unless the seating capacity of the bus is at least 20 adults (not including the driver).

State and local governments.—Otherwise taxable products or articles used by States and local governments are exempt from all Highway Trust Fund excise taxes.

President's Budget Proposal

Under the President's budget proposal, the exemptions from Highway Trust Fund excise taxes for alcohol fuels, buses, and State and local governments would be repealed.

This proposal would be effective October 1, 1987.

Pros and Cons

Arguments for the proposal

1. All users of the Federally financed highway system should bear part of the cost of the system.

2. Exemptions from highway user excise taxes discriminate against the tax paying users, and provide a tax subsidy to exempted users.

3. Exemptions from highway user excise taxes deprive the Highway Trust Fund of revenues to finance improvements and repairs to the system.

Arguments against the proposal

1. The exemptions for alcohol fuels encourage utilization of alternate fuel sources and reduces petroleum usage.

2. The exemptions for buses encourages greater usage of more fuel efficient transportation, thus reducing petroleum usage.

3. The exemption for State and local governments is part of a long standing mutual intergovernmental policy of tax comity with respect to excise taxes generally.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Repeal of current gasohol, bus, and State-local government highway excise tax exemptions	0.2	0.3	0.3	0.8

3. Airport and Airway Trust Fund Excise Taxes

Present Law

Excise taxes are imposed on users of the Federally financed aviation system. Receipts from these taxes are deposited into the Airport and Airway Trust Fund, and expenditures may be made from the Trust Fund for purposes authorized in the Trust Fund statute in the Internal Revenue Code.

The Airport and Airway Trust Fund excise taxes include—

(1) an 8-percent tax on air passenger transportation;

(2) a 5-percent tax on domestic air transportation of property;

(3) a $3-per-person international departure tax;

(4) a 12-cents-per-gallon tax on gasoline used in noncommercial aviation; and

(5) a 14-cents-per-gallon tax on nongasoline fuels used in noncommercial aviation.

Exemptions from the fuels excise taxes have been provided for aircraft museums and for certain helicopter uses which do not utilize the facilities and services of the Federal airport and airway system.

The taxes on air transportation apply to the purchase of transportation services for persons or property beginning before January 1, 1988. The taxes on noncommercial aviation fuels expire after December 31, 1987.

President's Budget Proposal

The President's budget proposal would extend the present-law airport and airway system excise taxes for two additional years (i.e., through December 31, 1989), and would provide a two-year reauthorization of the Airport and Airway Trust Fund programs (for fiscal years 1988-1989).

Other Possible Proposals

1. The present-law airport and airway excise taxes could be extended for 5 years, i.e., through December 31, 1992. (H.R. 2310, as approved by the House Committee on Public Works and Transportation on June 3, 1987, would provide a 5-year extension of the trust fund program authorizations, for fiscal years 1988-1992.)

2. The air passenger ticket tax could be increased from 8 percent to 10 percent, with the additional revenue to go into the general fund. Also, corresponding increases could be made in the air cargo tax and the international departure tax, with the additional revenues to go into the general fund.

Pros and Cons

Arguments for the proposals

1. The present-law airport and airway taxes should be extended to conform to the extension of the Trust Fund program authorizations.

2. Extension of the Trust Fund taxes is needed in order to prevent a reduction in net budget receipts (as CBO includes them in the baseline budget).

3. In a time of budget stringency, and if other specific excise taxes are to be increased, it is appropriate also to increase the air passenger and air cargo excise taxes for the budget deficit reduction effort. Increases in such excises are less regressive than for other Federal excise taxes.

Arguments against the proposals

1. Revenues from the aviation excise taxes should be reserved (and earmarked as under present law) for the Airport and Airway Trust Fund programs, as these taxes represent user charges for payment of Federal airport and airway system costs; thus, the taxes should be considered separately in the context of the proposed extension of the trust fund program authorizations. Any potential increase in such aviation excise taxes should be earmarked for needed expansion of the national aviation system and related air safety programs rather than for general revenues.

2. Increasing the aviation excise taxes could adversely affect the air passenger and air cargo industry.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
a. Extend present excise taxes	(*)	(*)	(*)	(*)
b. Increase air ticket tax to 10% and corresponding increases in the air cargo and departure taxes to $—	0.6	0.7	0.7	1.9

*Extension of present-law trust fund taxes do not result in any net increase in estimated budget receipts (included in CBO's baseline budget).

4. Imposition of Air and Ship Travel Tax

Present Law

Present law imposes no general excise tax on international travel to and from the United States. A $3 per person international departure tax is imposed, however, as part of the funding for the Airport and Airway Trust Fund, applicable to certain international departure flights exempt from the 8-percent domestic passenger ticket tax. (*See* 3., above.)

President's Budget Proposal

The President's budget proposes to impose an excise tax of $1 per ticket for international travel to and from the United States, its possessions, and its territories by airline or cruise ship carriers. Travel to and from Canada, Mexico, and travel to the United States that originates in U.S. possessions and territories would be exempt from the tax.

Revenue from this tax would be used to support international tourism and marketing activities, defined to include planning, developing and carrying out programs to stimulate and encourage foreigners to travel in the United States. The proposal would fund the $12 million annual budget of the U.S. Travel and Tourism Administration; any revenues collected in excess of the existing USTTA budget would go into the general fund of the Treasury.

This proposal would be effective January 1, 1988.

(On June 9, 1987, the House Appropriations Subcommittee on Commerce, Justice, State, and the Judiciary approved such a $1 "fee" on international airline and cruise ship passengers entering the U.S. as a part of the Subcommittee's fiscal 1988 appropriations bill.)

Pros and Cons

Arguments for the proposal

1. A specific revenue source would provide necessary funding of the U.S. Travel and Tourism Administration, which supports programs (now funded from general revenues) to encourage foreign tourism in the United States.

2. A tax on international air and ship travel to and from the United States would be less regressive than certain other excise taxes.

Arguments against the proposal

1. The proposed air and ship travel tax would impose an additional tax and administrative burden on international travel to and from the United States. There is already a $3 per person interna-

tional air passenger departure tax, which goes to the Airport and Airway Trust Fund (see above).

2. The U.S. Travel and Tourism Administration should be funded out of general revenues rather than from a new earmarked excise tax.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
Imposition of $1 air and ship travel tax	([1])	([1])	([1])	0.1

[1] Gain of less than $50 million.

5. Repeal of Crude Oil Windfall Profit Tax

Present Law

Present law imposes an excise tax (the "crude oil windfall profit tax") on the windfall profit element of the price of domestically produced crude oil when it is removed from the premises on which it was produced. Generally, the windfall profit element is the excess of the sale price over the sum of an adjusted base price plus the applicable State severance tax adjustment. The windfall profit element may not exceed 90 percent of net income attributable to a barrel of crude oil.

The tax rates and recent base prices applicable to taxable crude oil are as follows:

Category of Oil	Tax rate (percent)	Estimated base price [1] (dollars per barrel)
Tier 1 Oil (oil not in tiers 2 or 3):		
Integrated producer	70	$18.85
Independent producer	50	19.44
Tier 2 Oil (stripper and petroleum reserve oil):		
Integrated producer	60	21.29
Independent producer	30	NA
Tier 3 Oil:		
Newly discovered oil	[2] 22.5	28.54
Incremental tertiary oil	30	28.07
Heavy oil	30	23.91

[1] Estimate for third quarter of 1987 based on SOI Bulletin (Summer 1986). Tier-1 oil excludes North Slope oil.

[2] Phases down to 20 percent in 1988 and 15 percent in 1989 and subsequent years.

Independent producer stripper well oil is exempt from the tax. Additionally, crude oil from a qualified governmental or a qualified charitable interest, certain front-end oil, certain Indian oil, certain Alaskan oil and, in the case of qualified royalty owners, up to three barrels per day of royalty production, are exempt from the tax.

The windfall profit tax is scheduled to phase out over a 33-month period, beginning January, 1991, or earlier if revenues from the tax exceed a specified amount.

President's Budget Proposal

The President's budget proposal would repeal the crude oil windfall profit tax.

The proposal would be effective October 1, 1987.

Pros and Cons

Arguments for the proposal

1. At present price levels, the tax raises little or no revenue, yet producers must nevertheless incur the burdensome recordkeeping expenses associated with the tax. Based on the Congressional Budget Office's most recent forecast of petroleum prices, the windfall profit tax will raise little or no revenue over the next five years.

2. The windfall profit tax discourages exploration and production of domestic oil. The windfall profit tax is in effect a sales tax on domestic crude oil which cannot be passed on by the producer since the price of petroleum is set by foreign producers who are not subject to the tax. As a result of the tax, high-cost oil may not be produced, and exploration activities may be reduced.

3. The inflation-adjusted price of oil is now less than half of what it was when the Crude Oil Windfall Profit Tax Act was enacted. This change in circumstances justifies major change or repeal of the Act.

Arguments against the proposal

1. The price of oil is extremely volatile and past attempts to predict future oil prices have been fraught with error. Forecasters failed to foresee the rapid rise in petroleum prices following the October 1973 war and the rapid fall in petroleum prices in 1986. The unpredictable nature of oil prices suggests that revenue estimates of the windfall profit tax should be viewed with caution. An unforeseen crisis in the Middle East could send the world market price of oil soaring: in this event, repeal of the tax could result in a substantial revenue loss to the Federal government and a substantial windfall to oil producers.

2. The windfall profit tax minimizes adverse effects on exploration and development by setting higher base prices and lower tax rates for newly discovered, incremental tertiary, heavy, and stripper well oil.

3. In April of 1979, the Carter Administration announced that it would use its discretionary authority over oil prices to phase out price controls between June 1, 1979, and September 30, 1981. Members of Congress who favored price controls did not seek legislation against decontrol in return for Administration support for a tax on a portion of the profits attributable to decontrol. The Crude Oil Windfall Profit Tax Act of 1980 is a result of this compromise. Repeal of the tax would breach the compromise reached in 1980.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Repeal of windfall profit tax	(*)	(*)	(*)	(*)

*Under current oil price projections, no windfall profit tax revenues would be collected under present law for this period.

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C. PBGC Premiums

Present Law

Under present law, if a defined benefit pension plan is terminated by a sponsoring employer with assets insufficient to pay benefits guaranteed by the Pension Benefit Guaranty Corporation (PBGC), then the PBGC pays the monthly benefits required by the particular plan, up to the guaranteed levels. Subject to certain dollar limits, the PBGC guarantees nonforfeitable retirement benefits other than those that become nonforfeitable on account of the termination of the plan.[1]

Under the Single-Employer Pension Plan Amendments Act of 1985 (SEPPA), the sponsor of a single-employer defined benefit plan may terminate the plan only in a standard termination or a distress termination. A standard termination occurs when the assets in the plan are sufficient to pay all benefit commitments. Benefit commitments generally include all benefits guaranteed by the PBGC and all benefits that would be guaranteed but for the insurance limits on the amounts or value of the benefits. In a standard termination, the plan sponsor has no further liability to the PBGC after plan termination.

A distress termination occurs in certain cases of financial hardship, such as bankruptcy, the inability of the sponsor to pay its debts when due unless the plan is terminated, or if pension costs become unreasonably burdensome due to a declining workforce. In the case of a distress termination, the sponsor continues to be liable to the PBGC for the sum of (1) the total amount of all unfunded guaranteed benefits, up to 30 percent of the employer's net worth, (2) an amount equal to the excess (if any) of (a) 75 percent of the total amount of all unfunded guaranteed benefits over (b) the amount described in (1), and (3) interest on the amount due calculated from the termination date.

PBGC revenues include per-participant annual premiums with respect to defined benefit pension plans, earnings on investments, and collections from sponsors of terminated plans. Single-employer plans currently pay an annual premium of $8.50 per participant (up from $2.60 prior to 1986). The PBGC has limited authority to impose a variable rate premium.

Despite the 1986 increase in the premium rate and the SEPPA restrictions on the circumstances under which employers may terminate underfunded pension plans and shift pension liabilities to the PBGC, the termination of underfunded pension plans increased the PBGC's deficit from $1.3 billion as of September 30, 1985, to

[1] Present law requires that all benefits become nonforfeitable when a pension plan is terminated.

$3.8 billion as of September 30, 1986. Cash payments to retired workers are estimated to exceed PBGC income in 1988.

President's Budget Proposal

The President's budget proposal would authorize the PBGC to charge higher premiums to those employers who do not adequately fund their pension promises.

The President's proposal provides that the annual premium payable by a single-employer plan would consist of two main elements. Under the proposal, one element would consist of a minimum flat per-participant charge applicable to all single-employer plans. The flat per-participant charge would be indexed annually for inflation. The other proposed element would be a variable-rate funding charge based on the excess of a funding target over the level of plan assets. The proposal provides that the total of these two premium elements would not exceed a maximum of $100 per participant for the 1988 plan year. The $100 annual limit would be indexed.

The President's budget proposal provides that the funding charge rate would be reviewed at 3-year intervals and would be revised without the need for Congressional action. Under the proposal, the $100 limit on per-participant premiums would be indexed to 1.5 times the rate of wage growth.

The President's budget proposal also provides that a surcharge would be imposed for missed contributions (e.g., contributions for which a funding waiver has been granted). The surcharge would be equal to a percentage of the funding charge otherwise due. The surcharge would not be taken into account in applying the annual limit on per-participant premiums ($100 for the 1988 plan year).

The proposal would be effective January 1, 1988.

Pros and Cons

Arguments for the proposal

1. The proposed variable-rate premium is more equitable than the flat rate premium provided by present law. It would place the greatest burden on those employers whose plans present the greatest risk of potential loss to the PBGC.

2. A variable-rate premium would encourage more responsible funding of pension benefits. Employers would rather make contributions to their plans than pay premiums to the PBGC.

3. A flat-rate premium increase of the magnitude needed to fund anticipated liabilities of the PBGC could encourage the termination of well-funded plans because employers who have funded responsibly could incur a significant increase the per-participant cost of maintaining their plans without a corresponding increase in benefits.

4. A triennial review of the variable-rate element of the premium would provide advance assurance to employers that premiums will be adjusted to reflect changes in risk.

Arguments against the proposal

1. A variable-rate premium structure could unduly burden financially distressed plans and employers. The premium should not be

determined under strict insurance principles because of the need to encourage pension plans.

2. A variable-rate premium could have the effect of diverting funds from plans to the PBGC. The cost of paying premiums could force the premature termination of a plan and benefit loss for participants.

3. The premium proposed by the President does not appropriately measure the PBGC's risk with respect to a plan because it does not measure the financial condition of the employer who maintains the plan. Further, it fails to measure appropriately the PBGC's risk because it reflects a plan's termination liability, rather than its liability for benefits guaranteed by the PBGC. Under the proposal, a plan with assets that are more than sufficient to pay for all guaranteed benefits could, nevertheless, be required to pay an additional premium charge based on the plan's funding level.

4. The premium paid to the PBGC should be regarded as a tax because benefits under a plan are guaranteed by the PBGC whether or not the premium has been paid. It is not appropriate for the Congress to delegate to an administrative agency the determination of tax rates.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
PBGC premiums (negative outlay)	0.3	0.3	0.2	0.8

D. Certain New User Fees

1. Internal Revenue Service

Present Law

The Internal Revenue Service (IRS) currently does not charge taxpayers for issuing determination letters or private ruling letters. In 1984, the IRS issued 106,353 advance determination letters on the qualification of corporate and self-employed pension plans, and acted on 69,613 applications and ruling requests from tax-exempt organizations. The IRS also issued 34,246 private ruling letters in response to taxpayers' requests during 1984.

President's Budget Proposal

The President's budget proposes to impose user fees for each determination letter and private ruling letter issued by the IRS. The level of the fees is not specified. These fees are proposed to become effective on October 1, 1987.

Pros and Cons

Argument for the proposal

The Federal Government in recent years has expanded its revenue base by imposing so-called "user fees" for many government services. Currently, the IRS devotes considerable time and manpower to the preparation of determination letters and private letter rulings. The relatively small number of taxpayers who utilize these services should more directly pay these costs.

Argument against the proposal

It is inappropriate to impose a user fee on a taxpayer seeking an IRS determination or private letter ruling to adequately fulfill his legal responsibility to pay taxes. This situation is to be contrasted with an individual paying a user fee to visit a national park is generally acting voluntarily, rather than seeking to fulfill his legal responsibilities.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
Internal Revenue Service fees [1] ...	0.1	0.1	0.1	0.2

[1] The amount of revenues to be collected is directly linked to the level of the user fees. Because no level of user fees has yet been specified, it is assumed that the level will be set to collect approximately $0.1 billion annually (as indicated in the President's fiscal year 1988 budget).

2. Bureau of Alcohol, Tobacco, and Firearms

Present Law

The Treasury Department's Bureau of Alcohol, Tobacco, and Firearms (BATF) collects licensing fees and excise taxes on various types of firearms, pursuant to the Federal Gun Control Act (19 U.S.C. sec. 921 *et seq.*) and the Internal Revenue Code.

The Code imposes occupational taxes on brewers and on wholesale and retail dealers in liquor, wine and beer. The amount of these taxes ranges from $24 per year for retail beer dealers to $255 per year for wholesale liquor and wine dealers. BATF generally does not charge fees for permits related to alcohol and tobacco products.

President's Budget Proposal

The President's budget proposes increasing fees for services provided by BATF. These may include an increase in firearms licensing fees; imposition of fees for permits to produce alcoholic beverages (pursuant to the Federal Alcohol Administration Act), to engage in certain industrial uses of alcohol and to procure or use certain tax-free[2] or specially denatured distilled spirits; and imposition of licensing fees for occupations presently covered by alcohol occupational taxes. Similar fees would also be imposed on tobacco-related permits.

This proposal would be effective October 1, 1987.

Pros and Cons

Argument for the proposal

It is appropriate for BATF to charge special fees for firearms licensing, permission to produce alcoholic beverages, engage in certain industrial uses of alcohol, procuring or using certain tax-free or specially denatured distilled spirits, as well as charging fees for tobacco-related permits. Such fees would help offset the BATF cost of providing these regulatory services.

Argument against the proposal

Regulatory functions performed by BATF should continue to be funded from general revenues rather than specific fees. Revenues from the alcohol and tobacco excise taxes go into the general fund and therefore help support general governmental functions, including BATF administrative and regulatory efforts.

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[2] Tax-free uses covered by this provision include certain uses by State or local governments or for specified nonbeverage purposes (including laboratory and hospital uses).

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Bureau of Alcohol, Tobacco and Firearms fees	0.1	0.1	0.1	0.2

3. Customs Service

Present Law

As enacted in the Omnibus Budget Reconciliation Act of 1986, an *ad valorem* user fee is applied to all formal entries of merchandise imported for consumption in the amount of 0.22 percent during fiscal year 1987, dropping to 0.17 percent in fiscal year 1988, and expiring after September 30, 1989. The fee does not apply to articles classifiable in schedule 8 of the Tariff Schedules (including products containing U.S. components which are classifiable in item 807.00 of the Schedules).

President's Budget Proposal

The President's budget proposal would eliminate the exemption for articles containing U.S. components and would extend the fee beyond its scheduled expiration date.

The proposal would be effective July 1, 1986.

Pros and Cons

Arguments for the proposal

1. As a user fee, the customs *ad valorem* fee should be applied to all merchandise imported into the United States, rather than exempting certain articles.
2. Removal of the exemption would lessen the administrative burden of determining and valuing such exemption.
3. Making the Customs user fee permanent would remove uncertainty concerning its future application.
4. Elimination of the exemption would close off an avenue for a potentially significant loss of revenues.
5. Extension of the fee beyond fiscal year 1989 would help to reduce the out-year budget deficits by ensuring that the costs of customs operations are offset.

Arguments against the proposal

1. Applying the user fee to products containing U.S. components would increase the cost of such U.S. components.
2. The Customs user fee should not be made permanent at this time, to give the Congress sufficient time to review its impact and the appropriate level of the fee.
3. Importers who take advantage of the schedule 8 exemption may be adversely affected by the administrative burden imposed by this change.

Possible Other Proposal

The *ad valorem* customs user fee could be frozen at 0.22 percent for fiscal year 1988 and subsequent years.

Pros and Cons for Other Proposal

Argument for the proposal

Actual receipts for fiscal year 1987 at 0.22 percent are roughly equivalent to the cost of Customs' commercial operations, whereas the scheduled reduction in the fee level to 0.17 percent will not be sufficient to offset the rising commercial costs of the Customs Service.

Argument against the proposal

Importers have assumed that the fee would be reduced in fiscal year 1988 and may be adversely affected by freezing the fee at a higher level.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Customs Service user fees:				
a. President's proposal	0.1	0.2	0.6	0.9
b. Freeze fee at 0.22% and repeal schedule 8 exemption	0.1	0.3	0.8	1.4
c. Repeal schedule 8 exemption	0.1	0.2	([1])	0.3

[1] Gain of less than $50 million.

4. Coast Guard

Present Law

The Coast Guard provides various services to recreational and commercial boaters, including inspections, licenses, navigation aids, and search and rescue operations. These services are funded from general revenues.

President's Budget Proposal

The President's budget proposes a phased implementation of user fees for certain Coast Guard services. According to the proposal, fees for direct, transactional services (e.g., issuing licenses) would be set so as to recover the actual cost of providing the service. Additional fees would be set in proportion to the Coast Guard's cost of providing the service to each class of users (e.g., recreational, commercial fishing, and deep-sea and inland commercial users).

No fees would be charged for core governmental functions carried out by the Coast Guard (e.g., defense, law enforcement, and polar ice operations).

The user fee schedule that has been proposed for the Coast Guard includes an annual fee schedule for various vessels and other fees relating to licensing, inspections and documentation. The proposed fee schedule would provide that the receipts from the user fees are to be deposited in the general fund o. the Treasury as proprietary receipts of the department in which the Coast Guard is operating, and would ascribe those receipts to Coast Guard activities.

Vessel fees.—A summary of the annual vessel fee schedule follows.

PROPOSED ANNUAL FEES FOR VESSELS

Recreational boat	$37	
Inland tug	1,000	plus $5 per horsepower
Fishing vessel	750	plus $7.70 per ton over 5 tons
Mobile drilling unit	2,000	
Coastwise tug	1,000	plus $5 per horsepower
Coastwise vessel	1,000	plus $1.75 per ton over 5 tons per arrival
International vessel	552	

Port and environmental safety fee schedule.—Proposed fees range from $36 for a hot work permit to $550 for reception facility inspections.

Documentation of vessels.—Proposed fees range from $170 for initial certificate of documentation to $50 for certificate renewal.

Vessel inspection.—Proposed fees include—

(1) *Initial inspection*—from $1,000 plus $50 per gross ton for a small passenger vessel to $25,500 for a large passenger vessel.

(2) *Inspection for certification*—from $225 for an unmanned fixed platform to $4,080 for a nautical school ship.

(3) *Reinspection*—from $225 for fixed platforms to $2,040 for a liquid natural gas carrier, tank vessel, and bulk carrier of 75,000 tons or over.

(4) *Drydock examinations*—from $250 for a small passenger vessel to $3,825 for a tank vessel and bulk carrier of 75,000 gross tons or over.

Merchant vessel personnel.—Proposed fees range from $200 for issuing a license to $75 for a license renewal.

Effective date.—This proposal would be effective October 1, 1987.

Pros and Cons

Arguments for the proposal

1. The proposed fees would defray the expenses incurred by the Coast Guard in providing clearly identifiable services directly to beneficiaries.

2. The fees would be designed to recover the costs of providing services to recreational boaters, commercial fishing, and deep-sea and inland commercial operators. User fees would not be used to recover the costs of activities that provide benefits to the general public, such as, defense preparedness, law enforcement, and polar icebreaking operations.

3. By substituting user fees for general fund financing of these Coast Guard activities, inefficient transportation subsidies would be eliminated, and the general taxpayer would not subsidize some other individual's recreational or business activities.

Arguments against the proposal

1. It is not always possible to identify all the private beneficiaries of governmental services, and thus the government may erect competitive obstacles that affect some but not all competitors.

2. There may be substantial disagreement about whether a service or activity of the Coast Guard should be considered within a fee-for-service context; for example, navigational aids are used by the armed services as well, and once installed for their use, there is little or no additional cost to the Coast Guard in allowing commercial fishermen and shippers and recreational boaters to use the same navigational aids.

3. Some of the proposed user fees may not be within the jurisdiction of the Committee on Ways and Means.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
Coast Guard user fees	0.4	0.5	0.5	1.3

II. OTHER POSSIBLE REVENUE OPTIONS

A. Excise Taxes

1. Alcoholic Beverage Excise Taxes

Present Law

Under present law, excise taxes are levied on the production or importation of the three major types of alcoholic beverages: distilled spirits, wine, and beer. Also, occupational taxes are imposed on certain persons involved with the production or marketing of alcoholic beverages. The excise tax on distilled spirits was increased by $2.00 per proof gallon in 1984 (the only increase since 1951). The excise taxes on wine and beer were last increased in 1955.

The following is a summary of the excise taxes currently imposed on alcoholic beverages:

Beverage	Tax imposed
Distilled spirits	$12.50 per proof gallon
Beer	$9.00 per barrel generally [1]
Still wines:	
Up to 14 percent alcohol	$0.17 per wine gallon
14 to 21 percent alcohol	$0.67 per wine gallon
21 to 24 percent alcohol [2]	$2.25 per wine gallon
Champagne and sparkling wines	$3.40 per wine gallon
Artificially carbonated wines	$2.40 per wine gallon

[1] $7 per barrel for certain small brewers.
[2] Wines containing more than 24 percent alcohol are taxed as distilled spirits.

For example, the Federal excise tax on a one-fifth gallon bottle of 80-proof liquor is $1.05; on a six-pack of beer, approximately $0.16; and on a 750-milliliter bottle of still wine (less than 14 percent alcohol), about $0.03.

Possible Proposals

1. The alcoholic beverage excise tax rates could be doubled.
2. The tax rates in possible proposal 1 could be indexed for inflation, using the CPI.
3. The excise tax rates on wine and beer could be based on alcohol content (like the present distilled spirits tax), and at the present-law distilled spirits tax rate.
4. The distilled spirits tax rate could be doubled, with wine and beer tax rates also being based on alcohol content and being imposed at the increased distilled spirits tax rate.

5. The wine tax rates could be increased to equivalent rates to the present-law tax imposed on beer.

6. The beer tax rate could be doubled, and the wine tax rates increased to equivalent rates to the new tax imposed on beer.

7. The alcoholic beverage tax rates could be increased by 50 percent.

8. The reduction of the tax rate on alcohol content in distilled spirits that is attributable to wine or certain flavors could be repealed.

Pros and Cons

Arguments for the proposals

1. The present alcoholic beverage excise taxes are imposed at flat rates rather than being adjusted to reflect inflation. Despite the 1982 increase in the distilled spirits excise tax rate (the only increase since 1951), the effective rate of all of the alcoholic beverage excise taxes is less than it was in 1951 (distilled spirits) or in 1955 (wine and beer). For example, had the distilled spirits tax rate been indexed to the CPI in 1951, the present tax would be approximately $44.00 per proof gallon instead of $12.50 per proof gallon. Similarly, the taxes on wine and beer would be significantly higher. Increases in these taxes, therefore, are appropriate.

2. While excise taxes generally are viewed as affecting the poor more than the wealthy, i.e., as regressive, the alcoholic beverage excise taxes are imposed on discretionary purchases. Arguments against regressive taxes are less persuasive in the case of taxes imposed on discretionary purchases than in the case of taxes affecting necessities.

3. From a public policy perspective, alcoholic beverage excise taxes are appropriately imposed on alcohol content. Additionally, the three major types of alcoholic beverages are substitutes for each other and should be taxed at equivalent rates.

4. The Administration has proposed user fees to offset costs of administering programs of the Bureau of Alcohol, Tobacco, and Firearms. Increasing the alcoholic beverage excise tax rates is a possible alternative means of accomplishing this Administration proposal.

5. Alcohol-related deaths run as high as 100,000 per year. Estimated annual costs for business associated with alcohol abuse were as high as $113 billion in 1979, with two-thirds of the costs being productivity losses of workers. Studies have shown that increases in the alcoholic beverage taxes could have a substantial impact in reducing consumption.[1]

Arguments against the proposals

1. Excise taxes imposed at flat rates cost the poor a larger percentage of disposable income than the relative income share of wealthier individuals. According to a 1987 CBO study of excise taxes, alcohol expenditures are 10 times higher as a percentage of

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[1] Cook, Philip J., "The Economics of Alcohol Consumption and Abuse," *Alcoholism and Related Problems*, 1984; and *Impact of Alcohol Excise Tax Increases on Federal Revenues*, National Alcohol Tax Coalition, 1984.

income for the ten percent of the families with the lowest income than the percentage for the ten percent of families with the highest incomes.

2. Indexing the alcoholic beverage excise tax rates could lead to market distortions as the tax rates changed annually. Prevention of such distortions would require imposition of floor stocks taxes [2] whenever significant tax increases occurred. Floor stocks taxes may impose administrative burdens on retail and wholesale dealers in taxable articles.

3. State and local governments impose excise taxes on alcoholic beverages. Increasing Federal tax rates could preempt possible tax increases at the State and local levels at a time when other Federal assistance is being reduced due to Federal deficit problems.

4. The alcoholic beverage excise taxes represent a burden on one industry. Excessive deficits are a broad-based problem; deficit reduction should be accomplished by measures that spread the burden across all segments of the economy rather than unduly burdening a single industry.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal [1]	1988	1989	1990	1988–90
a. Double taxes on all alcoholic beverages:				
Distilled spirits	2.1	2.3	2.3	6.8
Beer	1.1	1.2	1.2	3.5
Wine	0.3	0.3	0.3	1.0
b. Index alcoholic beverage taxes after doubling:				
Distilled spirits		0.1	0.1	0.2
Beer		([2])	0.1	0.1
Wine		([2])	0.1	0.1
c. Increase beer and wine tax rates to present distilled spirits rate:				
Beer	3.3	3.4	3.4	10.1
Wine	1.7	1.8	0.9	5.5
d. Double distilled spirits tax rate and increase wine and beer tax rates to increased distilled spirits rate:				
Distilled spirits	2.1	2.3	2.3	6.8
Beer	7.2	7.4	7.5	22.1
Wine	3.5	3.6	3.9	11.0
e. Increase wine tax rate to present beer tax rate	0.4	0.4	0.4	1.1
f. Double beer tax rate and increase wine tax rate to increased beer rate:				
Beer	1.1	1.2	1.2	3.5
Wine	0.8	0.9	0.9	2.6

[2] Floor stocks taxes are special add-on taxes imposed on products held for sale beyond the regular point of taxation on the date of a scheduled increase in rate.

Revenue Effect—Continued

[Fiscal years, billions of dollars]

Proposal [1]	1988	1989	1990	1988–90
g. Increase alcohol taxes by 50%:				
Distilled spirits	1.2	1.2	1.2	3.7
Beer	0.6	0.6	0.6	1.8
Wine				
h. Repeal reduced tax on distilled spirits derived from wine	([1])	([1])	([1])	0.1

[1] All proposals except indexing would be effective on October 1, 1987, with appropriate floor stocks taxes being imposed. Indexing would be effective on January 1, 1989.

[2] Gain of less than $50 million.

2. Tobacco Products Excise Taxes

Present Law

Excise taxes are imposed on cigars, cigarettes, cigarette papers and tubes, snuff, and chewing tobacco manufactured in or imported into the United States. Substantially all of the revenue from these taxes is raised from the tax on "small cigarettes." Small cigarettes are cigarettes weighing no more than 3 pounds per thousand. The present rate for that tax has been in effect since 1982.

The following is a summary of the Federal excise taxes imposed on tobacco products under present law:

Article	Tax imposed
Cigars:	
Small cigars	$0.75 per thousand
Large cigars	8½ percent of wholesale price, up to $20 per thousand
Small cigarettes	$8.00 per thousand (16 cents per pack of 20 cigarettes)
Large cigarettes	$16.80 per thousand
Cigarette papers	$0.005 per 50 papers
Cigarette tubes	$0.01 per 50 tubes
Chewing tobacco	$0.08 per pound
Snuff	$0.24 per pound

Possible Proposals

1. The present excise taxes on tobacco products could be doubled (e.g., small cigarettes could be taxed at $0.32 per pack of 20 cigarettes, a $0.16 per pack increase).

2. The flat tax rates in possible proposal 1 could be indexed for inflation, using the CPI.

3. The present excise taxes on tobacco products could be doubled as provided in possible proposal 1 and tax could be imposed on pipe, etc. tobacco at $0.48 per pound (the new rate that would apply to snuff).

4. The present excise tax rate for small cigarettes could be increased by 50 percent to $0.24 per pack of 20 cigarettes (an $0.08 per pack increase) with comparable increases being enacted for all other tobacco products.

5. The present excise tax rate for small cigarettes could be tripled to $ 0.48 per pack of 20 cigarettes (a $0.32 per pack increase) with comparable increases being enacted for all other tobacco products.

Pros and Cons

Arguments for the proposals

1. The present tobacco product excise taxes are imposed at flat rates rather than being adjusted to reflect inflation. Despite the 1982 increase in the cigarette excise tax rates (the only such increase since 1951), the effective rate of these taxes is lower today than it was in 1951. Had the rates been indexed to the CPI in 1951, the present cigarette excise tax rate would be approximately 34 cents per pack of 20 small cigarettes rather than 16 cents. Higher tax rates are therefore appropriate.
2. Indexing the tobacco taxes would retain the real tax burden of these taxes as the general price level increases.
3. While excise taxes generally are viewed as affecting the poor more than the wealthy, i.e., as regressive, the tobacco excise taxes are imposed on discretionary purchases. Arguments against any regressive impact of taxes are less persuasive in the case of taxes imposed on discretionary purchases than in the case of taxes imposed on necessities.
4. The Administration has proposed user fees to offset costs of administering programs of the Bureau of Alcohol, Tobacco, and Firearms. Increasing the tobacco excise tax rates is a possible alternative means of accomplishing this Administration proposal.
5. The U.S. Surgeon General has identified cigarette smoking as the single most important source of premature death in the United States. At least one study has stated that 30 percent of deaths from heart disease and cancer are smoking related.[3] Another study has estimated additional health care costs of from $12 to $35 billion per year and between $27 and 61 billion per year in lost income result from smoking.[4] Increasing tobacco excise taxes is consistent with other Federal Government policies to discourage smoking because of the associated health hazards.

Arguments against the proposals

1. Excise taxes imposed at flat rates are regressive, i.e., they cost the poor a larger percentage of disposable income than they cost wealthier individuals making the same purchases. According to a January 1987 CBO study on the distributional aspects of selected Federal excise taxes, individuals with incomes below $5,000 and between $5,000 and $10,000 spent 7.89 and 3.33 percent, respectively, of income on tobacco purchases. The percentage declines steadily as incomes rise, falling to 0.54 percent for individuals with incomes of $50,000 or more.
2. Indexing the tobacco products excise tax rates could lead to market distortions as the tax rates changed annually. Prevention on such distortions would require imposition of floor stocks taxes [5] whenever significant tax increases occurred. Floor stocks taxes impose administrative burdens on retail and wholesale dealers in taxable articles.

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[3] *The Distributional Aspects of an Increase in Selected Federal Excise Taxes*, Congressional Budget Office Staff Working Paper, January 1987.

[4] Chandler, William U., *Banishing Tobacco*, Washington Worldwatch Institute, 1986.

[5] Floor stocks taxes are special add-on taxes imposed on products held for sale beyond the regular point of taxation on the date of a scheduled increase in tax.

3. State and local governments impose excise taxes on tobacco products. Increasing the Federal tax rates could preempt possible tax increases at the State and local levels at a time when other Federal assistance to such governments is being reduced due to Federal deficit problems.

4. The tobacco excise taxes represent a burden on one industry. Excessive deficits are a broad-based problem; deficit reduction should be accomplished by measures that spread the burden across all segments of the economy rather than unduly burdening a single industry.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal [1]	1988	1989	1990	1988–90
a. Double present tobacco excise tax rates	3.0	3.1	3.1	9.2
b. Index tobacco products tax at doubled rates	3.0	3.3	3.5	9.8
c. Double present tobacco excise tax rates and extend tax to pipe tobacco	3.1	3.1	3.1	9.3
d. Increase present tobacco excise tax rates by 50 percent	1.6	1.6	1.6	4.8
e. Triple present tobacco excise tax rates	5.7	5.8	5.8	17.3

[1] All proposals except indexing would be effective on October 1, 1987, with appropriate floor stocks taxes being imposed. Indexing would be effective on January 1, 1989.

3. Telephone Excise Tax

Present Law

Imposition of tax

A 3-percent excise tax is imposed on amounts paid for local and toll (long-distance) telephone service and teletypewriter exchange service. The tax is collected by the provider of the service from the consumer (business and personal service). The tax is scheduled to expire after December 31, 1987. (The telephone excise tax was last extended for two years (1986 and 1987) in the Deficit Reduction Act of 1984 (P.L. 98-369).)

Exemptions from the telephone excise tax are provided for installation charges, certain coin-operated service, news services (except local service), international organizations, the American Red Cross, servicemen in combat zones, nonprofit hospitals and educational organizations, State and local governments, and for toll telephone service paid by a common carrier, telephone or telegraph company, or radio broadcasting company in the conduct of its business. In addition, an exemption is provided for private communications systems (e.g., certain dedicated lines leased to a single business user).

Treasury study of exemptions

The Omnibus Budget Reconciliation Act of 1986 (P.L. 99-509) requires the Treasury Department to study the effects of the current exemption for private communications systems and the increasing incidence of so-called "by-pass" systems in which private businesses own and operate their own internal telephone systems rather than accessing the taxable systems operated by common carriers. Treasury also is to report on the appropriateness of other specific present-law exemptions from the telephone excise tax.

The Treasury Department study is to include revenue effects of all present-law telephone tax exemptions and descriptions of types of persons benefiting from such exemptions. The report is to be submitted to the House Committee on Ways and Means and the Senate Committee on Finance by June 30, 1987.

Possible Proposals

1. The existing three-percent telephone excise tax could be extended for three years (through 1990).
2. The three-percent telephone tax rate could be extended for three years, with the rate being increased to 5 percent for cellular and other mobile telephone usage.
3. The telephone excise tax could be increased to four percent for three years.
4. After a one-year extension at the present rate, the telephone tax could be phased out by 0.5 percentage points per year.

5. The present exemptions from the telephone tax could be repealed.

6. To limit avoidance of tax through private, by-pass telephone systems, a 10-percent excise tax could be imposed on all telephone equipment (including fiber optic links) and communications satellites sold to persons for use in a manner not subject to the telephone excise tax.

Pros and Cons

Arguments for the proposals

1. At the relatively low tax rate in effect in recent years, the telephone excise tax is not a heavy burden on individual or business taxpayers, yet taxpayers are accustomed to it and the tax provides needed Federal revenues.

2. The telephone excise tax does not disproportionately burden any regions of the country, and it is easily administered and collected.

3. The present exemptions from the telephone excise tax may no longer be appropriate, as they erode the potential telephone tax base and foster inequitable treatment of communications service users.

4. Imposing an excise tax on the sale of telephone equipment to persons other than telephone companies for taxable use would help eliminate tax-avoidance by private by-pass systems in which no common carrier is used.

Arguments against the proposals

1. There is no rationale, other than Federal revenue needs, for imposition of the telephone excise tax.

2. Recent FCC decisions have increased monthly access charges for all local telephone service. Allowing the tax to expire would partially offset those increases.

3. The cost of telephone service, particularly local service, is a necessary expenditure in today's society. As such, it may be inappropriate to impose an excise tax on such expenditures.

4. Consumer expenditures on telephone service are a relatively higher percentage of income for lower income families than for higher income families; thus, the tax has a regressive impact according to income levels.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal [1]	1988	1989	1990	1988–90
a. Extend present excise tax for three years (1988–1990)	1.3	2.3	2.5	6.0
b. Extend 3% tax with 5% rate for mobile telephone usage	1.3	2.3	2.5	6.1
c. Increase tax to 4% for three years	1.7	3.0	3.3	9.4
d. Phase out present tax, after one-year extension	1.3	2.0	1.8	5.1

Revenue Effect—Continued

[Fiscal years, billions of dollars]

Proposal [1]	1988	1989	1990	1988-90
e. Impose 10% excise tax on equipment sold to persons other than common carriers	0.4	0.6	0.7	1.7

[1] All proposals would be effective October 1, 1987, and would include floor stocks taxes in the case of the excise tax on certain equipment.

4. Luxury Excise Taxes

Present and Prior Law

Federal excise taxes have not been levied on a broad range of consumer items, whether or not such items could be called luxury items, since enactment of the Excise Tax Reduction Act of 1965.

Before enactment of the 1965 Act, retail, wholesale, and manufacturers taxes covered many consumer items without any exemption of items priced below threshold levels. Examples of the excise taxes, which were repealed in 1965 or later legislation, are listed below.

Manufacturers excise taxes

1. 10-percent tax on automobiles; 8-percent tax on automobile parts and accessories.
2. 10-percent tax on radio sets, television sets, phonographs, records, and other analogous items. (The same tax rate also applied to self-contained air-conditioning units, cameras, lenses and film, and business machines.)
3. 5-percent tax on film projectors.

Retail excise taxes

1. 10-percent tax on jewelry, various precious and semi-precious stones, watches, clocks, sterling silver, silver-plated, gold, or gold-plated holloware and flatware, and other items.
2. 10-percent tax on articles made of fur on the hide or pelt, and on articles with fur as the most valuable component.
3. 10-percent tax on toilet preparations (which included cosmetics as well as perfumes), handbags, and luggage.

Possible Proposals

1. *Ad valorem* excise taxes could be reimposed on the articles that were subject to excise taxes under prior law.
2. In addition to the prior-law taxes, taxes could be imposed at a 10-percent rate on the following articles:
   a. Boats and yachts;
   b. China and crystal;
   c. Airplanes, other than those used for the commercial transportation of passengers or cargo for hire;
   d. Electronic entertainment and recreational devices (e.g., VCRs, video cameras, recording tape and other accessories, etc.);
   e. Electronic or mechanical coin-operated amusement devices; and
   f. Social club dues.

3. Thresholds could be established for certain articles, with the taxes applying to the excess of price above the established threshold. For example, the tax on automobiles could apply to the excess of the price over $20,000, and the tax on boats and yachts could apply to the excess of the price over $15,000.

Under all three proposals, whether the taxes would be imposed at the manufacturer or retail level would be determined based on the relative ease of administering each tax.

Pros and Cons

Arguments for the proposals

1. Excise taxes have a direct effect on reducing consumption of the taxable items, and thus encourage savings.

2. Properly targeted, luxury excise taxes would affect wealthier individuals to a greater degree as a percentage of disposable income than the poor. Inclusion of such taxes in a revenue-raising package would help render such a package more progressive in its impact.

Arguments against the proposals

1. Administrative cost-revenue ratios associated with these excise taxes would be very high relative to the cost-revenue ratio of income taxes. Relative administrative costs are higher for retail excise taxes than for manufacturers excise taxes because of the greater number of retailers, and thus a greater number of returns to process. However, the determination of price in many transactions below the retail level is determined on the basis of negotiations or arbitrary prices set between manufacturers and wholesalers owned by the same person rather than set prices applicable to purchasers generally; taxes levied on such transactions tend to create even greater distortions in relative prices.

2. There are few objective standards available to use in deciding which articles are luxury goods.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal [1]	1988	1989	1990	1988–90
a. 10% tax on value of autos in excess of $20,000	0.3	0.4	0.4	1.2
b. 10% tax on value of boats, yachts in excess of $15,000	0.1	0.1	0.1	0.3
c. 10% tax on value of general aviation aircraft	0.2	0.3	0.3	0.8
d. 10% tax on value of furs	0.1	0.1	0.1	0.2
e. 10% tax on value of consumer electronic entertainment products (including TVs, radios, stereo equipment, VCRs, video cameras, and related products)	1.5	2.8	3.0	7.3
f. 10% tax on value of jewelry and precious gemstones in excess of $100	0.2	0.4	0.4	1.1

[1] All proposals would be effective on October 1, 1987, with appropriate floor stocks taxes being imposed.

5. Firearms Excise Taxes

Present Law

Two manufacturers excise taxes are imposed with respect to firearms under present law. First, tax is imposed at 10 percent of sales price on the sale of pistols and revolvers and at 11 percent of sales price on the sale of rifles, shotguns, and ammunition.

Second, a special $200-per-firearm excise tax is imposed to regulate the production of machine guns, destructive devices (e.g., bombs, grenades, mines, etc.) and certain other concealable firearms.

Revenues equivalent to the 10-percent and 11-percent excise taxes are dedicated to financing of the Federal Aid to Wildlife Program for support of State wildlife programs.

Possible Proposals

Both of the present excise taxes on firearms could be doubled. In the case of the 10-percent and 11-percent taxes, the additional revenues could be retained in general revenues rather than being dedicated to support State wildlife programs.

Pros and Cons

Arguments for the proposals

1. If excise taxes are to be increased for deficit reduction, it is appropriate to increase all such taxes, rather than singling out specific taxes and industries.

2. Tax rates have not been increased on pistols and revolvers since 1955, and since 1940 in the case of the 11-percent tax on other firearms and ammunition.

Argument against the proposals

Revenues from certain of these excise taxes historically have been dedicated to the Federal Aid to Wildlife program. Because of the relatively small amounts of revenue involved, continued dedication of all revenues from these taxes to support of wildlife programs is appropriate.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal [1]	1988	1989	1990	1988-90
Double present firearms taxes	0.1	0.1	0.1	0.3

[1] The proposal would be effective on October 1, 1987, with appropriate floor stocks taxes being imposed.

6. Pollution Excise Taxes

a. Excise tax on sulfur and nitrogen emissions

Present Law

Sulfur dioxide and nitrogen oxide emissions are not taxed under present law.

Possible Proposal

An excise tax could be imposed on emission into the atmosphere of sulfur dioxide and nitrogen oxides from any boiler or furnace which is used to burn fossil fuels for steam production. A variable rate of tax could be imposed depending on the emissions rate.

A 25-percent income tax credit, earned ratably over 10 years, could be allowed for investment in pollution control equipment.

Pros and Cons

Arguments for the proposal

1. A tax on sulfur dioxide and nitrogen oxide emissions would create an incentive for boiler operators to reduce such emissions which have been linked to acid rain.
2. Emissions reductions may be achieved with lower costs to industry and government by imposition of an emissions tax as compared with alternative policies such as power plant emission limitations.

Arguments against the proposal

1. An emissions tax would raise domestic manufacturing costs, making it more difficult for U.S. producers to compete with foreign producers in both the domestic and world markets.
2. Taxpayers would be required to calculate on a continuous basis taxable emissions of sulfur dioxide and nitrogen oxides. This could require costly monitoring or fuel content analysis.
3. An emissions tax would discourage use of high-sulfur coal. This would adversely affect employment and profits in the high-sulfur coal mining industry, which is concentrated in Appalachia and the midwestern portion of the United States.

b. Tax on ozone depleting chemicals

Present Law

Chemicals which deplete the ozone layer are not subject to tax under present law.

Possible Proposal

An excise tax could be imposed on the sale or use by the manufacturer of ozone depleting chemicals and on the import of such chemicals, or products containing such chemicals. Ozone depleting chemicals include chlorofluorocarbons ("CFCs") which are used as refrigerants, foam blowing agents, and solvents; methyl chloroform; carbon tetrachloride; and halon. The tax rate per pound could vary according to the ozone depleting potential of the chemical.

Pros and Cons

Arguments in favor of the proposal

1. A tax on ozone depleting chemicals would reduce their production and use in the United States.
2. U.S. chemical companies would have an incentive to develop substitute chemicals that do not deplete the ozone layer. To the extent that substitutes are developed, U.S. chemical companies may be able to increase domestic market share relative to imports.

Arguments against the proposal

1. Unless exports are exempt from tax, domestic manufacturers of ozone depleting chemicals would be placed at a competitive disadvantage in the world market relative to foreign producers.
2. There is scientific controversy over the extent to which CFCs and other chemicals contribute to the depletion of the ozone layer. Also the amount of ozone depletion caused by any particular chemical may vary according to its use by the purchaser.
3. Taxation of imported products containing ozone depleting chemicals would be complex to administer.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
a. Sulfur and nitrogen emissions tax of 45 cents per pound	6.4	6.9	5.7	19.0
b. Tax on ozone-depleting chemicals ($1 per pound of CFC–11 or equivalent in 1988, $2 in 1989, and $3 in 1990)	0.3	0.5	0.7	1.6

7. Energy Consumption Taxes

a. Broad-based energy tax

Present Law

Under present law, a variety of excise taxes and tariffs are imposed on the sale, use, or importation of chemical and mineral fuels. These include: the Highway, Aquatic Resources, Airport and Airway, Inland Waterway, and Leaking Underground Storage Tank Trust Fund taxes on gasoline, diesel fuel, and other motor fuels; the Superfund taxes on petroleum and certain chemical feedstocks; the Black Lung Disability Trust Fund tax on coal; and the tariff on imported crude petroleum and certain petroleum products.

Motor fuels taxes

Excise taxes are imposed on gasoline and special motor fuels (9 cents per gallon), diesel fuel (15 cents per gallon), aviation gasoline (12 cents per gallon), aviation jet fuel (14 cents per gallon), and fuel used by inland waterway vessels (10 cents per gallon). Revenues from these taxes are dedicated respectively to the Highway (Aquatic Resources for motorboat fuels), Airport and Airway, and Inland Waterway Trust Funds. An additional 0.1-cent-per-gallon tax is imposed on these fuels to finance the Leaking Underground Storage Tank Trust Fund. The highway and motorboat taxes are scheduled to expire after September 30, 1993; the aviation taxes are each scheduled to expire after December 31, 1987; the inland waterways tax is scheduled to phase up from 10 cents to 20 cents per gallon over the period 1990-1995; and the leaking underground storage tank tax expires on December 31, 1991, or earlier if $500 million of revenue is collected.

Superfund taxes

Receipts from a petroleum tax, a tax on chemical feedstocks, and a tax on certain imported substances derived from taxable feedstocks (effective January 1, 1989) are deposited into the Hazardous Substance Superfund to pay for the cleanup of hazardous waste sites.

Petroleum tax

A tax of 8.2 cents per barrel of domestic crude oil and 11.7 cents per barrel of imported petroleum products is imposed on the receipt of crude oil at a U.S. refinery, the import of petroleum products and, if the tax has not already been paid, on the use or export of domestically produced oil. The petroleum tax expires on December 31, 1991, or earlier if the Superfund unobligated balance exceeds a certain level or total Superfund revenues exceed a certain amount.

Tax on feedstock chemicals

A tax on feedstock chemicals applies to the sale or use of 42 specified organic and inorganic chemicals ("feedstock chemicals") by the manufacturer, producer, or importer. The tax rates range from 22 cents to $4.87 per ton. (A special rate applies to xylene to compensate for refunds of tax previously paid with respect to xylene.) Exports of taxable chemicals and certain taxable substances made from taxable chemicals are exempt from tax. Other exemptions include taxable chemicals used to make animal feed, fertilizer, and motor fuel. The tax on feedstock chemicals expires on December 31, 1991, or earlier, under the same circumstances as the tax on petroleum.

Tax on certain imported substances

Certain substances derived from taxable chemical feedstocks are subject to tax, when sold or used by the importer, according to their taxable chemical content. If the importer does not furnish sufficient information to determine the taxable chemical content, a 5-percent tax is imposed on the customs value of the imported substance. The tax on imported substances is effective January 1, 1989, and terminates at the same time as the tax on chemical feedstocks.

Coal tax

The black lung excise tax on coal is $1.10 per ton in the case of coal from underground mines and 55 cents per ton in the case of coal from surface mines, or if less, 4.4 percent of the price for which the coal is sold. Receipts from this tax are placed in the Black Lung Disability Trust Fund to pay benefits to miners who suffer from pneumoconiosis or their survivors. On January 1, 1996, or earlier under certain circumstances, the tax rates are scheduled to return to the pre-1982 rates (i.e., 50 cents per ton for underground mines and 25 cents per ton for surface mines, limited to 2 percent of price).

Tariff on imported petroleum

A tariff of 0.125 cent per gallon is imposed on crude petroleum, topped crude petroleum, shale oil, and distillate and residual fuel oils derived from petroleum, with low density (under 25 degrees A.P.I.). For substances with higher densities (testing 25 degrees A.P.I. or more), the tariff is 0.25 cent per gallon. (Imports from certain communist countries are subject to a 0.5-cent-per-gallon tariff, regardless of density.) A 1.25-cents-per-gallon tariff (2.5 cents, for certain communist countries) also is imposed on certain motor fuels and a 0.25-cent-per-gallon tariff (0.5 cent, for certain communist countries) is imposed on petroleum-derived kerosene and naphthas (except motor fuels). Natural gas, together with methane, ethane, propane, butane, and mixtures thereof may be imported tariff-free. Certain Canadian petroleum also may be admitted tariff-free, subject to an exchange agreement allowing like treatment for an equivalent amount of U.S. petroleum imported into Canada.

Possible Proposals

BTU tax

A tax could be imposed on domestic energy consumption equal to a fixed amount per BTU.[6] Renewable energy sources like solar and wind energy and synthetic fuels could be exempted. If the tax is limited to U.S. energy consumption, fuel imports would be subject to tax and fuel exports would be exempt.

Ad valorem energy tax

A second broad-base energy tax option would be to impose a tax on domestic energy consumption according to fuel value. Under this alternative, the stage at which the tax is imposed is important since value is added to fuels through the refining, processing, transportation, and marketing levels. The closer to the wellhead, mine mouth, or power plant a particular *ad valorem* tax is imposed on an energy product, the lower will be the receipt from a tax imposed at a particular rate on any product. Utilities could be allowed a credit for tax paid on fuels used to generate electricity to avoid double taxation.

A variant would be to impose a fixed-rate tax on different fuels (e.g., so much per barrel, cubic foot, ton, or kilowatt-hour) designed to approximate an *ad valorem* tax. These tax rates could be adjusted annually based on fuel price indices. To reduce the number of taxpayers, the tax could be imposed at the refinery level in the case of petroleum, at the city gate in the case of natural gas, at the mine mouth in the case of coal, and at the utility company level in the case of electricity.

If the tax is limited to U.S. energy consumption, fuel imports would be subject to tax and fuel exports would be exempt.

Pros and Cons

Arguments for the proposals

1. Energy consumption has various costs which are not reflected in energy prices and thus are not taken into account by consumers in making decisions about energy consumption. These costs include higher prices which must be paid to foreign producers, decreased national security associated with high oil import levels, and pollution of the environment. Energy consumption taxes would increase prices to reflect these costs, and thus would reduce these costs as consumption of energy declined.

2. In many applications, one fuel may be substituted for another, such as natural gas for oil to fire a boiler. Thus, increasing excise taxes on only one fuel type may cause energy users to switch to other fuel sources. By contrast, a broad-base Btu or *ad valorem* energy tax would be relatively neutral with respect to fuel choice, and could not be avoided by fuel switching.

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[6] A BTU, or British thermal unit, is a measure of energy content. One BTU is the amount of energy needed to raise the temperature of one pound of water by one degree Farenheit. One million BTUs are contained in 975 cubic feet of natural gas, 7.2 gallons of crude oil, 80 pounds of coal, or 293 kilowatt-hours of electricity.

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3. Taxing all energy consumption rather than only selected energy products results in a larger tax base; thus a given amount of revenue can be raised, without disproportionate regional burdens, at a lower rate of tax.

Arguments against the proposals

1. Any broad-base tax on energy consumption would increase the cost of domestic manufacturers and decrease their ability to compete with foreign manufacturers in the domestic and world markets. Statutory devices to relieve exports from the impact of the tax would be difficult to administer.

2. Energy taxes (like many consumption-based taxes) are regressive, affecting low-income households relatively more severely than high-income households.

3. There would be high administrative and compliance costs associated with the establishment of a broad-base energy tax which would be difficult to justify unless the tax were designed to raise substantial revenue. In addition, the complexity of such a tax would necessitate a delayed effective date.

4. If domestic energy products are taxed at the same rate as imports, there would be no incentive for increased domestic energy production.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Tax on coal, hydroelectric and nuclear power, natural gas and petroleum:				
$0.20 per thousand Btu	9.8	10.3	10.5	30.6
5 percent of value	12.2	13.8	14.6	40.6

NOTE.—Assumes effective date of January 1, 1988.

b. Broad-based petroleum tax

Present Law

Superfund taxes of 8.2 cents per barrel for domestic crude oil and 11.7 cents per barrel for imported petroleum products are imposed on the receipt of crude oil at a U.S. refinery, the import of petroleum products and, if the tax has not already been paid, on the use or export of domestically produced oil.

Domestic crude oil subject to tax includes crude oil condensate and natural gasoline, but not other natural gas liquids. Taxable crude oil does not include oil used for extraction purposes on the premises from which it was produced, or synthetic petroleum (e.g., shale oil, liquids from coal, tar sands, biomass), or refined oil.

Petroleum products which are subject to tax upon import include crude oil, crude oil condensate, natural and refined gasoline, refined and residual oil, and any other hydrocarbon product derived from crude oil or natural gasoline which enters the United States in liquid form.

The petroleum tax generally expires on December 31, 1991. The tax would terminate earlier than that date if cumulative Superfund receipts during the reauthorization period equal or exceed $6.65 billion, and under certain other conditions.

Possible Proposal

The Superfund taxes on domestic and imported crude oil and petroleum products could be increased, with receipts from the increased tax being deposited in general revenues.

Pros and Cons

Arguments for the proposal

1. A tax on domestic and imported petroleum could be accomplished by increasing the existing Superfund petroleum tax; thus start-up and administrative costs would be relatively low compared to a new broad-base energy tax (such as the BTU or ad valorem energy taxes described above).

2. A tax on domestic and imported petroleum would encourage conservation and thus reduce petroleum imports and import dependence.

Arguments against the proposal

1. A tax on petroleum would increase the costs of domestic manufacturers and decrease their ability to compete against foreign producers in both the domestic and world markets. Statutory devices to relieve exports from the impact of the tax would be difficult to administer.

2. A tax on petroleum would favor natural gas, coal, and nonfossil fuel energy sources over petroleum, with no incentive for increased domestic oil production.

3. A tax on crude oil would raise the price of all petroleum products. For example, a $1 per barrel import fee would raise the price of gasoline by approximately 2.3 cents per gallon.

4. A tax on petroleum would impose a larger burden on low-income households relative to high-income households, since low-income households spend a larger portion of their disposable income on petroleum products.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
$1.25-per-barrel tax on all oil consumption	5.0	5.2	5.2	15.4
$2.50-per-barrel tax on all oil consumption	10.0	10.1	10.1	30.1
$5.00-per-barrel tax on all oil consumption	19.6	19.1	18.9	57.6

c. Oil import tax

Present Law

Superfund tax on petroleum

A tax of 8.2 cents per barrel of domestic crude oil and 11.7 cents per barrel of imported petroleum products is imposed on the receipt of crude oil at a U.S. refinery, the import of petroleum products and, if the tax has not already been paid, on the use or export of domestically produced oil.

Petroleum products which are subject to tax upon import include crude oil, crude oil condensate, natural and refined gasoline, refined and residual oil, and any other hydrocarbon product derived from crude oil or natural gasoline which enters the United States in liquid form.

The petroleum tax generally expires on December 31, 1991. The tax would terminate earlier than that date if cumulative Superfund receipts during the reauthorization period equal or exceed $6.65 billion, and under certain other conditions.

Canada, Mexico, and the European Community filed a formal complaint under the General Agreement on Tariffs and Trade ("GATT") after the Superfund tax on imported oil was raised above that on domestic oil in the Superfund Reauthorization Act of 1986. A GATT panel convened to investigate the complaint concluded that the differential petroleum tax rate is contrary to the GATT, and the panel ruling was accepted unanimously by the GATT Council on June 17, 1987. Under GATT rules, the United States either must amend the Superfund tax or compensate the plaintiffs to avoid possible retaliatory tariffs.

Tariff on imported petroleum

Tariffs are imposed on various categories of articles that are imported into the customs territory of the United States (including the 50 states, the District of Columbia, and Puerto Rico). The tariffs generally are imposed at a uniform rate on imports from most noncommunist countries, with separate, higher rates imposed on imports from certain communist nations. Preferential treatment applies to certain imports from developing countries, specified Caribbean basin nations, and Israel. Imports from U.S. insular possessions, where the imported product is not comprised primarily of foreign materials, may be made duty-free. Tariffs are imposed pursuant to the Tariff Act of 1930 (19 U.S.C. sec. 1202 *et seq.*), and generally are subject to GATT limitations.

At present, a tariff of 0.125 cent per gallon is imposed on crude petroleum, topped crude petroleum, shale oil, and distillate and residual fuel oils derived from petroleum, with low density (under 25 degrees A.P.I.). For substances with higher densities (testing 25 degrees A.P.I. or more), the tariff is 0.25 cent per gallon.[7] (Imports from certain communist countries are subject to a 0.5-cent-per-gallon tariff, regardless of density.) A 1.25-cents-per-gallon tariff (2.5 cents, for certain communist countries) also is imposed on certain motor fuels and a 0.25-cent-per-gallon tariff (0.5 cent, for certain communist countries) is imposed on petroleum-derived kerosene and naphthas (except motor fuels). Natural gas, together with methane, ethane, propane, butane, and mixtures thereof may be imported tariff-free. Certain Canadian petroleum also may be admitted tariff-free, subject to an exchange agreement allowing like treatment for an equivalent amount of U.S. petroleum imported into Canada.

Import fee authority

Under the Trade Expansion Act of 1962, the President can impose oil import fees or import quotas if he finds that imports threaten the nation's security. Congress may roll back such fees by passing a joint resolution of disapproval; however, this resolution can be vetoed by the President, in which case the fees he imposed would continue in effect unless the President's veto is overridden by a two-thirds vote of both Houses of Congress. These procedures for Congressional vetoes and overrides were specified by the Crude Oil Windfall Profit Tax Act of 1980 (P.L. 96-223).

Under an exemption from the General Agreement on Tariffs and Trade (GATT), a tariff imposed on national security grounds is not a violation of trade agreements. Consequently, enactment of a tariff on imported petroleum for legitimate national security reasons would not result in the imposition of GATT-authorized countervailing duties or other trade penalties.

The presidential import fee authority was used, to various extents, by Presidents Nixon, Ford, and Carter. President Nixon imposed import license fees of 21 cents per barrel for crude oil and 63 cents on refined products in 1973 (this differential was intended to encourage domestic refining). President Ford imposed an additional $2-per-barrel crude oil import fee in 1975, but lifted the fee early in 1976. President Carter raised the possibility of an import fee in 1977 and again in 1979, in response to which Congress adopted the veto and override provisions contained in the Crude Oil Windfall Profit Tax Act. (Both the Ford import fee and the original Carter proposal were intended to encourage action on broader energy proposals.) President Carter actually imposed a $4.62 per barrel import fee in 1980, with allocation rules that effectively converted the fee into a 10-cents-per-gallon gasoline tax. However, a resolution of disapproval was passed by the Congress, and President Carter's veto of that resolution was overridden.

Possible Proposals

Increase petroleum tariff rates

The existing tariffs on imported crude oil and petroleum products could be increased. Alternatively, the Superfund tax on imported petroleum products could be increased with the additional

[7] Degrees API equals 141.5 divided by specific gravity, less 131.5.

revenue allocated to the general fund of the Treasury. Exemptions could be allowed for petroleum used in agriculture, in the manufacture of exports, and as home heating oil. Imported petroleum products could be taxed at a higher rate than imported crude oil.

Impose a floor price on imported petroleum

An excise tax or tariff could be imposed on imported petroleum equal to the excess of a specified floor price over an index of the world market price of crude oil. The effect of such a variable import fee would be to prevent the domestic price of crude oil from falling below the floor price.

Tax domestic and imported petroleum with a production credit for domestic producers

The Superfund tax on domestic crude oil and imported petroleum products could be increased by $5 per barrel, with the proceeds deposited in the general fund of the Treasury. The burden on domestic producers could be offset in part by a credit equal to the excess of $20 over the world market price of oil, up to $5 per barrel. This option is equivalent to a $5 per barrel import fee when the world oil price is less than $15 per barrel, and is equivalent to a $5 tax on both domestic and imported petroleum when the world oil price exceeds $20 per barrel.

Pros and Cons

Arguments for the proposals

1. A petroleum import fee would protect domestic oil producers from the decline in world oil prices which has occurred over the last two years.
2. Higher oil prices would encourage conservation and domestic exploration and production, and would discourage imports and abandonment of marginal wells. Reduced import dependence would improve the security of U.S. energy supply.
3. A petroleum import fee would improve the financial situation of banks with large portfolios of energy loans.
4. A variable import fee designed to maintain the domestic price of oil above a floor price would tend to stabilize domestic energy prices and provide some protection to domestic producers against a future collapse in oil prices. The supply of capital to the petroleum industry likely would increase as a result of such price protection.

Arguments against the proposals

1. A tax on imported petroleum would increase the costs of domestic manufacturers and decrease their ability to compete against foreign producers in both the domestic and world markets. Statutory devices to relieve exports from the impact of the tax would be difficult to administer.
2. A tax on imported petroleum would impose a larger burden on low-income relative to high-income households, since poorer households spend a larger portion of their disposable income on petroleum products.
3. A tax on imported oil would raise only about one-third of the revenue of a tax imposed on both domestic and imported petrole-

um. Exempting domestic production in effect transfers about two-thirds of the potential revenue as a windfall to domestic producers.

4. A tax or tariff on imported petroleum would adversely affect Mexico, Canada, the United Kingdom, and other non-OPEC oil producers who jointly supplied over half of the petroleum imported into the United States in 1986. Also, such a tax or tariff would violate the GATT unless covered by the national security clause.

5. A variable import fee designed to establish a floor under the price of domestic petroleum would fail to raise revenue if the world price were to rise above the floor price.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
Oil import tax:				
$4-per-barrel tax, no exemptions	6.5	5.9	5.9	18.3
$5-per-barrel tax, no exemptions	8.0	7.0	6.9	21.9
$5-per-barrel tax on imported crude oil, $7.50-per-barrel tax on imported refined petroleum products	8.6	7.2	7.0	22.8
Tax equal to the excess of $24 over the weighted-average price of imported crude oil on all imported crude and refined petroleum products; exemption for petroleum products used in agriculture, home heating oil, and in the manufacture of products for export	12.1	5.7	4.9	22.7
Tax equal to the excess of $24 over the weighted-average price of imported crude oil on all imported crude and refined petroleum products	15.7	9.7	8.7	24.1
$5-per-barrel tax on imported and domestic oil; credit equal to excess of $20 over the world price of oil for domestic production, limited to $5	8.0	7.0	7.0	21.9

8. Motor Fuels Excise Taxes

a. Increase in excise tax rates

Present Law

Four separate excise taxes are imposed on gasoline, diesel fuel, and special motor fuels under present law. A tax of 9 cents per gallon is imposed on gasoline and special motor fuels and a tax of 15 cents per gallon is imposed on diesel fuel used in highway vehicles; revenues from these taxes are deposited in the Highway Trust Fund.

Fuels used in commercial aviation (i.e., aviation carrying passengers or cargo for hire) are exempt from the tax. Fuels used in general aviation are subject to the general motor fuels excise taxes, plus a special, add-on tax. Revenues from these taxes on aviation gasoline are deposited in the Airport and Airway Trust Fund.

A tax of 0.1 cent per gallon is imposed on gasoline, special motor fuels, and diesel fuel (including such fuel used in nonhighway uses such as trains and all aviation gasoline); revenue from this tax is deposited in the Leaking Underground Storage Trust Fund (LUST).

Fuels used in vessels engaged in transportation on specified commercial inland waterways are subject to a separate excise tax, receipts from which are deposited in the Inland Waterways Trust Fund. This excise tax presently is 10-cents per gallon, and is scheduled to increase to 20-cents per gallon beginning in 1995. The waterways fuel tax does not apply to marine water transportation.

Exemptions from some or all these taxes are provided for fuels sold for export, for use by State and local governments, for use by nonprofit educational organizations. Fuels used in farming are exempt from the Highway Trust Fund taxes. Additionally, a partial exemption is provided from the Highway Trust Fund taxes for certain fuels blended with alcohol.

The Highway Trust Fund taxes are scheduled to expire after September 30, 1993. The LUST taxes are scheduled to expire after December 31, 1991, or earlier if revenues from the tax reach a specified amount. The Airport and Airway Trust Fund taxes are scheduled to expire after September 30, 1987.

Possible Proposals

1. The excise taxes on all motor fuels used in highway uses could be increased by 5 cents per gallon or by 10 cents per gallon.
2. After increasing the motor fuels excise taxes on motor fuels used in highway uses as provided in possible proposal 1, the taxes could be indexed for inflation using the CPI.
3. The increases in possible proposal 1 could be limited to gasoline and special motor fuels (i.e., diesel fuel used in highway uses would continue to be taxed at 15.1 cents per gallon).

4. Possible proposal 1 could be adopted, with the taxes being expanded to apply to nonhighway uses (e.g., trains, aviation, and shipping) that are subject to the LUST tax.

Pros and Cons

Arguments for the proposals

1. Increased motor fuels taxes may reduce domestic consumption as a result of increased prices. Reduction in the amount of petroleum products consumed in the United States promotes greater energy self-sufficiency, which helps achieve an important national security objective.

2. Since manufacturers use only a small proportion of the motor fuels consumed in the United States, a tax on motor fuels would have relatively little effect on U.S. competitiveness in international trade.

3. Increasing the motor fuels taxes on as many types of transportation as possible would avoid competitive disadvantages among industry segments.

4. Motor fuels are taxed at substantially higher rates outside the United States. In 1982 (fourth quarter) the energy tax on gasoline in the 10 major International Energy Agency countries was 91.3 cents per gallon versus an average Federal-State tax of 15 cents per gallon in the United States (the Federal excise tax on highway motor fuels was increased from 4 cents to 9 cents per gallon in 1983, and the tax on diesel fuel was increased from 9 cents to 15 cents per gallon in 1984.) [8]

Arguments against the proposals

1. Excise taxes imposed at a flat rate are regressive, i.e., they cost the poor a larger percentage of available income than the taxes cost wealthier individuals making the same purchases. In 1985, gasoline expenditures were 17.04 percent of income for persons with income of less than $5,000 and only 2.28 percent of income for persons with income of more than $50,000.[9]

2. The taxes on motor fuels have been imposed exclusively as earmarked transportation user taxes for over thirty years. Use of these taxes for general deficit reduction would be viewed by some as an inappropriate violation of this policy.

3. Increased taxes on diesel fuel may encourage evasion of the tax through use of untaxed home heating oil, which is essentially equivalent to diesel fuel, as a motor fuel.

4. The burden of the highway motor fuels taxes is greater in the sparsely populated States where distances traveled per capita is greater than the national average.

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[8] *International Energy Review*, Energy Information Administration, August 1985.

[9] *The Distributional Aspects of an Increase in Selected Federal Excise Taxes*, Congressional Budget Office Staff Working Paper, January 1987.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal [1]	1988	1989	1990	1988–90
Increase present Highway Trust Fund motor fuels tax rates by—				
5 cents per gallon	4.7	4.5	4.5	13.7
10 cents per gallon	9.3	9.0	8.8	27.1
Index present highway use motor fuels tax rates to CPI after 10-cent increase in rate	9.3	9.7	10.3	29.4
Increase present highway use motor fuels tax rates (other than diesel fuel tax) by—				
5 cents per gallon	4.0	3.8	3.8	11.6
10 cents per gallon	7.9	7.5	7.4	22.8
Increase present highway use motor fuels tax rates and extend tax to LUST tax base with increases of—				
5 cents per gallon	5.0	4.9	4.8	14.7
10 cents per gallon	10.0	9.6	9.4	28.9

[1] All proposals except indexing would be effective on October 1, 1987, with appropriate floor stocks taxes being imposed. Indexing would be effective on January 1, 1989.

b. Collection of gasoline and diesel fuel excise taxes

Present Law

Gasoline excise tax

The excise tax on gasoline is imposed on the sale of the product by the producer, defined to include a registered wholesale dealer. Beginning on January 1, 1988, tax will be imposed on removal of the gasoline (or a gasoline blend stock) from the refinery, or upon its removal from customs custody. An exception is included under the new rules permitting bulk transfers to bonded terminals without payment of tax. In such cases, terminal operators are liable for payment of the tax upon removal of the gasoline from the terminal.

Diesel fuel and special motor fuels excise taxes

The diesel fuel and special motor fuels excise taxes generally are imposed on the sale of the taxable fuel by a retail dealer to the ultimate consumer of the fuel. Under an exception, retail dealers may elect to have wholesale distributors collect and pay the tax when the diesel fuel is sold to the retailer.

Possible Proposals

Gasoline excise tax

The gasoline tax could be collected in all cases on removal of the gasoline (including any gasoline blend stock) from the refinery, or upon removal from the first storage point in U.S. customs custody.

Diesel fuel and special motor fuels excise taxes

The election to collect the diesel fuel excise tax on sales by wholesale dealers could be made mandatory for all sales. The special motor fuels excise tax could likewise be imposed on sale of the fuel by a wholesale distributor.

Pros and Cons

Arguments for the proposals

1. Deferring imposition of the motor fuels excise taxes until sale at or near retail has, in the past, encouraged tax-avoidance schemes. Imposing these taxes at an earlier stage in their marketing would reduce opportunities for evading payment of the fuels taxes.

2. Collection of excise taxes at the point in the distribution chain with the fewest number of taxpayers provides for more efficient administration of the tax since there are fewer taxpayers for the Internal Revenue Service to monitor.

3. Collecting these excise taxes at a uniform point eliminates any special advantage for a single industry segment (e.g., integrated operations *versus* independent wholesale distributors).

Arguments against the proposals

1. Much blending of gasoline is accomplished after gasoline blend stocks leave the refinery. Collecting the tax exclusively upon removal from the refinery would produce administrative complexity when additional tax (with credits for tax previously paid) was imposed on products blended after the initial point of taxation in a manner that increased the quantity of the product.

2. Advancing the point of collection for excise taxes forces small businesses to inventory these costs when they purchase the taxable commodity. The increased cost resulting from buying gasoline tax-paid could impose financial hardship on some small wholesale dealers.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal [1]	1988	1989	1990	1988–90
Collect gasoline tax at refinery gate	0.3	([2])	([2])	0.3
Collect diesel fuel and special motor fuels taxes on sale to retail dealer	0.1	0.1	0.1	0.4

[1] Both proposals would be effective on October 1, 1987, with appropriate floor stocks taxes being imposed.

[2] Gain of less than $50 million.

c. Income tax credit and excise tax exemption for certain alcohol fuels

Present Law

Alcohol fuels credit

A 60-cents-per-gallon income tax credit is allowed for alcohol used in certain mixtures of alcohol with gasoline (i.e., gasohol), diesel fuel, or any special motor fuel, if the mixture is (i) sold by the producer for use as a fuel or (ii) used as a fuel by the producer. The credit also is permitted for alcohol (other than alcohol used in a mixture with other taxable fuels), if the alcohol is used by the taxpayer as a fuel in a trade or business or is sold at retail by the taxpayer and placed in the fuel tank of the purchaser's vehicle.

The amount of any person's allowable alcohol fuels tax credit is reduced to take into account any benefit received with respect to the alcohol under the excise tax exemptions for alcohol fuels mixtures or alcohol fuels (described below).

Excise tax exemptions for alcohol fuels mixtures and alcohol fuels

Alcohol fuels mixtures

Present law provides a 6-cents-per-gallon exemption from the excise taxes on gasoline, diesel fuel, and special motor fuels for mixtures of any of those fuels with at least 10-percent alcohol. (This is equivalent to 60 cents per gallon of alcohol in a 10-percent mixture.)

"Neat" alcohol fuels

A 6-cents-per-gallon exemption from the excise tax on special motor fuels is provided for certain "neat" methanol and ethanol fuels derived from a source other than petroleum or natural gas. A 4½-cents-per-gallon exemption is provided for these fuels when derived from natural gas. "Neat" alcohol fuels are fuels comprised of at least 85 percent methanol, ethanol, or other alcohol.

Possible Proposals

The credit and excise tax exemptions for alcohol fuels could be repealed. (The President's 1987 and 1988 budget proposed repeal of the excise tax exemptions only.)

Pros and Cons

Arguments for the proposal

1. The alcohol fuels tax incentives are inefficient because they provide as excessive subsidy to alcohol fuels. For example, the 60-cents-per-gallon credit (or the equivalent excise tax exemption) pro-

vides a Federal subsidy equal to $25.20 per barrel of oil equivalent, an amount higher than the cost of gasoline.

2. The gasoline and other motor fuel excise taxes and the alcohol fuels credit were enacted as user taxes to finance, on a pay-as-you-go basis, construction of the interstate highway system; the excise tax exemption is contrary to this objective in exempting certain highway users from tax.

3. A subsidy no longer is needed for a gestation period for a new industry, since the successful ethanol-producing technologies are well known now and subsequent changes are more likely to be incremental refinements than major technological changes.

Arguments against the proposal

1. Tax incentives are necessary to encourage development and maintenance of viable alternatives to petroleum fuels. This is particularly true, given the high level of U.S. dependence on imported oil and the associated national security consequences.

2. Since the interstate highway system is virtually complete, the case for protecting highway user tax revenues is weakened.

3. Production of ethanol for use as a motor blending agent helps to use up some surplus agricultural products.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal [1]	1988	1989	1990	1988-90
Repeal alcohol fuels excise tax exemptions and alcohol fuels credit	0.2	0.2	0.2	0.7

[1] The proposal would be effective on October 1, 1987, with appropriate floor stock taxes being imposed.

9. Gas Guzzler Excise Tax

Present Law

Under present law, an excise tax is imposed on automobiles that do not meet statutorily specified fuel economy standards. The amount of the tax varies according to the fuel efficiency of a particular model of automobile. For 1986 and later model year automobiles, no gas guzzler tax is imposed if the fuel economy of the automobile model is at least 22.5 miles per gallon (as determined by the Environmental Protection Agency). For automobiles not meeting that standard, the tax imposed begins at $500 per automobile and increases to $3,850 for automobile models with fuel economy of less than 12.5 miles per gallon. Some limousines, pickup trcks, vans, and the output of small manufacturers are exempt from the tax. The gas guzzler tax is imposed on the manufacturer or importer.

Possible Proposals

1. The rates of the gas guzzler tax could be doubled.
2. The fuel economy standards could be tightened by increasing those standards by one mile per gallon for each of the model years 1990 through 1994.
3. The exemptions from the tax could be eliminated.
4. The Customs Service, rather than the IRS, could collect the tax on all imported vehicles.
5. The tax could be indexed for inflation.

Pros and Cons

Arguments for the proposals

1. Increasing the tax would improve the fuel economy of vehicles sold in the United States, which would be beneficial from an energy policy standpoint. Although the levels of the tax increased each year from 1980 through 1986, no further increases are scheduled after 1986.
2. The gas guzzler tax can be considered a voluntary tax, because consumers can choose to purchase automobiles not subject to the tax instead of choosing automobiles subject to the tax.
3. Some imported vehicles on which the tax should be imposed because of the level of their fuel efficiency may escape the tax, because they are imported privately or through the grey market. (Collection by the Customs Service of the tax on imported cars would reduce this problem.)

Arguments against the proposals

1. Increasing the fuel economy standards without substantial lead time could present difficulties for manufacturers, who general-

ly require significant lead time to improve the fuel efficiency of automobiles.

2. The tax is not directly related to energy conservation, because the tax is not proportional to the amount of fuel consumed.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal [1]	1988	1989	1990	1988–90
a. Double present tax	0.1	0.1	0.1	0.2
b. Increase mileage limits			([2])	([2])

[1] All proposals except indexing would be effective on October 1, 1987; indexing would be effective on January 1, 1988.

[2] Gain of less than $50 million.

10. Increase Trust Fund Excise Taxes to Offset Implicit General Fund Contributions to Such Funds

Present Law

Revenues equivalent to gross receipts from several present-law Federal excise taxes are dedicated to trust funds and may be used only for specified purposes. For example, revenues equivalent to gross receipts raised by the gasoline tax are dedicated to the Highway Trust Fund for use in highway-related programs.

The net revenue derived by the Federal Government from imposition of such taxes and tariffs is less than the gross receipts from such taxes or tariffs. This occurs because excise tax revenues displace other consumer expenditures and thus reduce taxable incomes in other sectors by an equal amount; income taxes are thereby reduced. Because amounts equivalent to gross receipts, rather than net revenues to the Treasury, are transferred to trust funds under present law, all trust funds receive an implicit appropriation from general revenues.

In many instances, other Federal tax expenditures provide an additional trust fund contribution from general revenues. For example, the revenue loss from tax-exempt bonds issued by State or local governments to finance activities for which they are reimbursed with Federal trust fund monies (e.g., highway and airport construction), or for which the users generally are the same as those who pay particular trust fund taxes, is not deducted from amounts transferred from general revenues to established trust funds.

The following table lists the current Federal trust (or special) funds and selected excise taxes, revenues from which are dedicated to the funds:

Fund	Dedicated Taxes
Highway Trust Fund	Gasoline, diesel fuel, and special motor fuels taxes Heavy truck retail excise tax Use tax on heavy trucks Tax on tires for heavy highway vehicles
Airport and Airway Trust Tax	Air passenger ticket tax International departure tax Domestic air cargo tax General aviation fuels taxes
Hazardous Substance Superfund	Tax on feedstock chemicals Crude oil tax Tax on certain imported substances
Oil Spill Liability Trust Fund	Crude oil tax [1]
Leaking Underground Storage Storage Tank Trust Fund	Gasoline and motor fuels taxes
Harbor Maintenance Trust Fund	Port use tax
Inland Waterways Trust Fund	Tax on fuels used by commercial cargo vessels
Aquatic Resources Trust Fund	Tax on fuels used in motorboats Sport fishing equipment tax
Black Lung Disability Trust Fund	Coal excise tax
Deep Seabed Trust Fund	Tax on mining of certain hard minerals from the seabed
Pittman-Robertson Fund	Bows and arrows taxes Manufacturers tax on certain firearms and ammunition

[1] This tax will be effective only if qualified authorizing legislation is enacted by September 1, 1987.

Possible Proposals

1. All Federal excise taxes that are dedicated to trust (or special) funds could be increased by 33 percent to offset the implicit contribution to those funds from general revenues from the reduction in income tax receipts arising from imposition of excise taxes, with the additional revenues being retained in general revenues rather than being transferred to the trust funds.

2. In addition to possible proposal 1, specific trust (or special) fund taxes could be increased by an additional amount equivalent to the revenue loss from outstanding tax-exempt bonds to finance trust fund and related activities. As provided in possible proposal 1,

the additional revenues could be retained in general revenues rather than being transferred to the trust funds.

Pros and Cons

Arguments for the proposal

1. Spending programs the funding of which is derived from special, dedicated taxes should not be underwritten with general revenues, absent an explicit determination by Congress to appropriate such amounts. Some trust-fund-related programs currently are funded by such explicit appropriations from general revenues. Continuation of the implicit general revenue transfers that occur under the current trust fund procedure where transfers are based on gross receipts rather than net revenues is an evasion of the appropriations process.

2. Basing transfers to trust funds on net revenues, rather than on gross receipts as is presently done, would ensure a more accurate link between revenue source and program beneficiary in those cases where Congress has determined that funding for specified programs should be limited to that derived from program beneficiaries.

3. The explosive growth of tax-exempt bond issuance, with its accompanying Federal revenue loss, has been a source of concern to Congress in recent years. Reducing trust fund transfers to reflect the revenue loss from such bonds used to finance trust fund projects would appropriately transfer the cost of the bonds from taxpayers generally to users of trust fund facilities without directly limiting or otherwise affecting the use of tax-exempt bonds to finance such facilities.

Arguments against the proposals

1. In addition to the specific beneficiaries of trust fund programs (i.e., persons who pay the dedicated taxes), there is a general public benefit derived from most such programs. The implicit transfer from general revenues under present trust fund practices recognizes this benefit and appropriately assigns its cost to the population at large.

2. Sales to the Federal Government and to State and local governments are exempt from certain of the trust fund excise taxes. These governments, representing the population at large, benefit from the trust fund programs under present law. The implicit general revenue contributions like those presently occurring are one method of assigning the cost of the benefits received by these governmental units to ultimate beneficiaries.

Revenue Effect

Proposal [1]	1988	1989	1990	1988-90
a. Increase trust fund excise tax rates by 33 percent	4.4	4.7	4.9	14.0
b. Increase trust fund excise tax rates by additional amount over 33 percent to offset revenue loss from outstanding tax-exempt bonds	9.2	9.8	10.1	29.0

[1] Both proposals would, be effective on October 1, 1987, with appropriate floor stocks taxes being imposed.

11. Federal Unemployment Tax Act (FUTA) Provisions

a. Index FUTA wage base

Present Law

The minimum net FUTA tax imposed on employers is 0.8 percent of the first $7,000 of wages paid to each employee during the year. The gross FUTA tax rate is 6.2 percent, but employers in States meeting certain Federal requirements and having no delinquent Federal loans are eligible for a 5.4-percent credit, making the minimum net FUTA tax rate 0.8 percent.

Possible Proposal

The $7,000 limit on wages subject to the FUTA tax could be indexed to reflect the annual increase in average wages. In order to allow States time to make the required conforming changes, the proposal would be effective for years after 1988.

Pros and Cons

Argument for the proposal

Indexing the FUTA wage base generally would maintain the FUTA tax revenues as a constant percentage of total wages.

Argument against the proposal

Additional FUTA revenues should be generated only in response to specific needs relating to unemployment compensation, rather than in response to a general concern for revenue.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Index FUTA wage base (effective January 1, 1989)		0.2	0.6	0.8

b. Extension of portion of FUTA due to expire after 1987

Present Law

Under present law, the gross FUTA tax rate of 6.2 percent of the first $7,000 in wages paid to an employee consists of a permanent component of 6.0 percent and a temporary component of 0.2 percent. (The net FUTA tax is 0.8 percent after taking into account the 5.4 percent credit for State unemployment taxes.) The funds generated by the temporary portion of the tax have been used to repay advances made from general revenues to the Extended Unemployment Compensation account. These advances have been utilized to pay for the Federal Supplemental Benefit program and the Federal share of the permanent extended benefit program.

The temporary 0.2-percent tax component is scheduled to expire at the beginning of the first year following the year in which the advances from general revenues are repaid. The advances were fully repaid in 1987. As a result, for the year beginning January 1, 1988, the FUTA tax rate will be 6.0 percent (0.6 percent after taking into account the 5.4 percent credit for State unemployment taxes).

Possible Proposal

The temporary FUTA tax component of 0.2 percent could be extended three years through 1990.

Pros and Cons

Argument for the proposal

In light of the current budget situation, it is inappropriate to allow a reduction in a tax to which employers have become accustomed.

Arguments against the proposal

1. The temporary FUTA tax component of 0.2 percent was intended to serve a specific purpose, i.e., to repay certain advances. Since that purpose has been served, the tax should be allowed to expire.

2. The reduction in the FUTA tax will encourage the employment of low-income workers and will offset the increase in employer social security taxes scheduled for 1988.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Extended FUTA repayment tax for 3 years	0.7	1.0	1.0	2.7

B. General Consumption Taxes

Present Law

Present law does not include any form of broad-based consumption tax. Manufacturers' and retailers' excise taxes are imposed on the sale of selected products. These taxes are not sufficiently uniform or coordinated to be considered as a general consumption tax system.

A value added tax bill was introduced by the Chairman of the Ways and Means Committee in the 96th Congress (and hearings held), but was not reported out of Committee. The 1984 Treasury Department Report to the President on "Tax Reform for Fairness, Simplicity, and Economic Growth," examined the VAT concept, but did not recommend inclusion of such a tax in the Administration's tax reform proposals.

Possible Proposals

1. Value added tax ("VAT")

A value added tax is a multi-stage sales tax on the value added to goods and services by each business in the production and distribution chain. Since the retail price of a product is equal to the total of the values added at each stage of production and distribution, a value added tax is the economic equivalent of a retail sales tax.

Tax liability may be calculated in a number of ways. All of the member countries in the European Economic Community use the "invoice" or "credit" method. Under this method, a firm calculates the tax on its sales, and is allowed to claim a credit for the tax imposed on its purchases. Any excess of tax imposed on purchases over the tax due on sales is either refunded or carried forward as a credit against future tax liability. Imports are subject to the VAT, and the VAT on exports is credited or rebated.

Under a consumption-type VAT, a credit for tax on capital equipment purchases eliminates the burden of the tax on capital goods. Since only consumption goods bear the tax, the incidence of the tax is on consumers. The consumption-type VAT is used throughout Europe. There are, in addition to the consumption VAT, two other types of VAT. The gross product type does not allow any credit for the tax paid on capital items. Under the income type VAT, the tax paid on a capital item is credited over the life of the asset.

2. Business alternative minimum tax ("BAMT")

As an alternative to the invoice method, a multi-stage sales tax could be imposed using the subtractive method. Under the subtractive method, a firm computes its tax liability by subtracting its purchases from other firms from its sales, and by applying the tax rate to the difference. The BAMT uses the subtractive method: a tax would be imposed on net business receipts, which are defined as the excess of any business receipts over business expenses during the taxable period. The tax also would be imposed on imports. Business receipts attributable to exports would be exempt from tax.

Credits could be allowed for (1) the employer's share of FICA and Railroad Retirement tax liabilities, and one-half of self-employment tax liability, (2) income tax liability (reduced by income tax credits), and (3) the tax equivalent of net operating losses.

Revenues from the BAMT could be used to provide a capital gains exclusion, reinstate a 5-percent investment credit, repeal the alternative minimum tax, lower income tax rates, as well as to reduce the Federal budget deficit.

Pros and Cons

Arguments for the proposals

1. Under the General Agreement on Tariffs and Trade ("GATT"), sales taxes may be imposed on a destination basis (place of consumption) rather than an origin basis (place of production). Thus, unlike an income tax, a sales tax may be imposed on imports and rebated on exports.
2. A number of studies of alternative tax systems have concluded that a broad-base consumption tax would result in greater long-run capital formation and GNP than an equal revenue broad-base income tax.
3. The subtractive method used to compute the BAMT may be less burdensome to taxpayers than the invoice method.
4. Under the BAMT, the credit for a portion of the payroll taxes mitigates the regressive impact to some extent. Specific exclusions for certain necessities (e.g., food, housing and medical costs) or increases in transfer payments could lessen the regressivity.

Arguments against the proposals

1. The 1984 Treasury Report on tax reform concluded that implementation of a Federal value-added tax would take 18 months from the date of enactment and, when fully in force, would require an additional 20,000 personnel, and would cost about $700 million to enforce.
2. A VAT is a sales tax which largely would be borne by consumers. The burden of such a tax likely would be regressive.
3. The BAMT does not operate as a conventional minimum tax since tax liability is unrelated to profitability: for example, taxpayers with losses could have substantial BAMT liability. Also, the allowance of a credit for origin-based taxes (i.e., payroll and income taxes) against the BAMT may be a technical violation of the GATT.
4. Many empirical studies of savings behavior have failed to find a significant relationship between individual savings rates and marginal income tax rates. Thus, substitution of consumption for income taxes may not have a large effect on national savings.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988 [1]	1989	1990	1988–90
5-percent VAT	69.5	100.7	103.4	
5-percent VAT with exceptions for food, housing, and medical care	40.2	58.3	59.8	
7-percent BAMT [2]	27.8	41.2	43.9	112.9

[1] Assumes effective date of January 1, 1988.

[2] Estimate does not include revenue reduction attributable to possible BAMT credits (for FICA, income tax liability, and NOLs) or to possible other revenue offsets, such as a capital gains exclusion, 5-percent investment credit, or repeal of the alternative minimum tax.

C. Securities Transfer Excise Tax

Present Law

Under present law, no tax is imposed upon the transfer of corporate stock or any other security, other than income taxes attributable to any gain realized by the transferor. Transfer taxes were imposed, however, on transfers of certain securities from 1918 to 1965. Immediately prior to repeal in 1965, the transfer tax was imposed at a rate of 0.1 percent of value on the original issue and 0.04 percent on subsequent transfers of stock, and was imposed at a rate of 0.05 percent on the original issue and 0.05 percent on the subsequent trading of certificates of indebtedness.

Possible Proposals

1. A securities transfer excise tax ("STET") could be imposed at a rate of 0.5 percent of value upon transfers of certain securities. The securities subject to the tax could include stock and debt securities, whether or not publicly traded, options, futures, forward contracts, and other items, such as limited partnership interests, that are close substitutes to the above securities.

The transfers subject to the STET could include sales or exchanges, gifts, transfers at death, transfers pursuant to divorce, transfers to a trust, transfers pursuant to mergers or acquisitions, and transfers upon issuance or redemption of a security. Special rules would apply to transactions with certain elements and to pass-through entities.

2. The rate of tax in possible proposal 1 could be 1.0 percent of value.

Pros and Cons

Arguments for the proposal

1. If revenues are to be raised by increasing Federal excise taxes, a STET should be preferred to other options because the likely high concentration of securities ownership among higher income taxpayers would make a STET more progressive than many other Federal excise taxes.

2. Because the STET would not be paid directly by the population at large (unlike, e.g., the income tax), there may be less opposition to the STET than to an increase in certain other taxes.

3. A reduction in securities trading, especially short-term trading, that is likely to occur as a result of the imposition of a STET, would be beneficial because large amounts of stock in the hands of investors with short-term investment objectives place undue pressure on corporate managers to achieve short-term results at the expense of more effective long-term strategies.

4. Imposition of a STET would discourage speculative, short-term, high-risk trading by managers of pension funds; these risks are inappropriate for the management of funds intended for retirement use.

5. Imposition of a STET would reduce merger and acquisition activity which has resulted in insider trading abuses as well as the diversion of managerial efforts.

Arguments against the proposal

1. The progressivity of a STET would be limited because a significant amount of wealth is held by pension funds on behalf of lower- and middle-income individuals.

2. Imposition of a STET would increase the cost of capital to firms if pre-tax yields on securities issued after the effective date are increased to compensate for the additional tax burden.

3. The reduction in short-term trading that may be attributable to a STET may be undesirable because active short-term trading provides valuable signals to management regarding shareholder perceptions of corporate strategies, and also increases liquidity and decreases volatility of security prices.

4. A STET imposed in the United States could encourage some participants in U.S. capital markets to transfer their securities to foreign exchanges which had no such tax or a tax with a lower rate.

Revenue Effect

The revenue effect of a STET would be heavily dependent on precisely how the tax is structured. In the absence of a specific proposal and in order to provide some indication of the order of magnitude of the revenue effect, the following is presented for a reasonable broad based securities transfer tax of 0.5 percent.

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990
0.5 percent	5.0	7.5	10.0

D. Income Tax Provisions

1. Individual and Corporate Tax Rates and Surtaxes

Present Law

Individuals

In the Tax Reform Act of 1986, tax structures for each of the four filing classifications, which had 14 or 15 marginal tax rates and taxable income brackets, were replaced by a five-step marginal rate structure for 1987 and by two marginal rates and a phaseout rate for 1988 and later years. The zero bracket amounts of prior law have been replaced by the standard deduction, which is deducted from adjusted gross income in the process of determining taxable income.

In 1987, the marginal tax rates are 11 percent, 15 percent, 28 percent, 35 percent, and 38.5 percent. The maximum tax rate on long-term capital gain in 1987 is 28 percent.

There are two marginal tax rate brackets—15 percent and 28 percent—for each filing classification for 1988 and later years. In addition, some taxpayers in effect will be subject to a 33-percent tax rate on taxable income above specified amounts; this phaseout tax rate will apply as income rises until the tax benefits of the 15-percent bracket and the personal exemption amount deductions have been phased out. The 33-percent phaseout rate reverts to 28 percent for income levels above that at which the phaseout has been completed. Beginning in 1988, long-term capital gain will be taxed as ordinary income; a transitional maximum capital gains rate of 28 percent applies in 1987.

Corporations

Through June 30, 1987, the corporate income tax rate structure has a top rate of 46 percent, which applies to taxable income in excess of $100,000. Lower marginal tax rates apply to taxable income less than $100,000, but the tax benefit of the lower rates is phased out (beginning at taxable income above $1 million). The lower marginal rate structure is 15 percent on taxable income to $25,000; 18 percent between $25,000 and $50,000; 30 percent between $50,000 and $75,000; and 40 percent between $75,000 and $100,000.

Under the Tax Reform Act of 1986, a new corporate tax rate structure will become effective on July 1, 1987. This structure has a top corporate tax rate of 34 percent, which applies to taxable income in excess of $75,000. Below $75,000, a 15-percent rate applies to taxable income to $50,000, and 25 percent to $75,000. A phaseout of the 15- and 25-percent tax rates begins at taxable income above $100,000.

For taxable years that include parts of both tax rate structure periods, taxpayers will apply the two tax rate structures in proportion to the number of days in the taxable year that includes each of the tax structures. For example, in the case of a calendar year corporate taxpayer with $2 million of ordinary taxable income, the tax for 1987 is computed by first determining a tentative tax under prior law of $920,000 (46 percent of $2 million) and a tentative tax under the amended law of $680,000 (34 percent of $2 million). The actual tax equals the sum of $456,219.18 (181/365 of $920,000) and $342,794.52 (184/365 of $680,000) or $799,013.70, for a total tax rate of approximately 40 percent.

Corporate net capital gain properly taken into account after December 31, 1986, is taxed at a 34-percent rate.

Possible Proposals

1. Provide a five-percent surtax on individual and corporate income tax liabilities, including individual and corporate minimum tax liabilities.
2. Provide a five-percent surtax on individual and corporate income tax liabilities, including individual and corporate minimum tax liabilities, above $10,000.
3. Extend the 1987 tax rate schedules for both individuals and corporations for one year through 1988, for a longer period (with indexing), or indefinitely (with indexing).
4. Create an third marginal tax rate of 33 percent for individuals that would apply to taxable income at and above the level at which the phaseout of the tax benefits of the 15-percent rate bracket and personal exemptions applies.
5. The same as (4) above, except add a 38.5-percent tax bracket that begins at taxable income above $225,000 (on a joint return) and retain the maximum capital gains tax rate at 28 percent.

Pros and Cons

Arguments for the proposals

1. Taking into account the provisions of the 1986 Act that broadened the income tax base and provided fairer treatment of all taxpayers, the relative income tax burden of each taxpayer would not be disturbed if the income tax liabilities of all taxpayers are increased by the same proportion.
2. Compared to many excise tax options, an income tax surcharge would not discriminate among products or geographic regions.
3. A surtax would involve little additional compliance or collection costs because withholding and estimated payments simply would be increased by the amount of the surtax.
4. A precedent for an income tax surtax was established in the Revenue and Expenditure Control Act of 1968 (enacted on June 28, 1968) in which a 10-percent surtax was imposed on individual tax liabilities (effective as of April 1, 1968) and on corporate tax liabilities (effective as of January 1, 1968). The surtax expired on June 30, 1970.
5. If a surtax or an increase in marginal tax rates were enacted, a surtax on minimum tax liability or a proportionate increase in

minimum tax rates would be necessary to maintain all taxpayers in the same relative position.

6. Proposals (4) and (5) would eliminate the phaseout and provide permanent 33- and 38.5-percent tax rate brackets, thereby eliminating the inequity under present law of allowing the highest income taxpayers to pay a 28-percent tax rate on taxable income above the phaseout range where the 33-percent phaseout rate applies. For example, on a joint return, a taxpayer could be paying 28 percent on taxable income above $200,000 while another taxpayer with $145,000 taxable income would be paying a 33-percent phaseout rate.

In addition, there is a widespread perception that the tax rate cut for high income individuals was excessive, and that the top marginal tax rate should be different for, e.g., married taxpayers with taxable incomes of $70,000, $150,000, and $500,000.

7. The amount of a taxpayer's income is the best measure of ability to pay taxes. An income tax surtax or increase in marginal tax rates would not be regressive relative to income, as increases in excise taxes tend to be.

Arguments against the proposals

1. Any increase in tax rates, whether in the form of a temporary surtax or an increase in all or selected tax rates, would be an increase in rates that would break a pledge made to taxpayers on enactment of the base-broadening and other provisions of the Tax Reform Act of 1986 that eliminated or reduced deductions, credits, etc.

2. Any need to increase budget receipts through the income tax would be met best by enacting additional base-broadening provisions, which also would increase the equity of the tax structure even further. As a result, greater compliance is more likely to be achieved because low- and middle-income taxpayers would believe that the income tax system would be even more fair to all income groups.

3. Increased income tax rates would have adverse effects on economic efficiency—reduced savings, reduced work effort, and other distortions.

4. Increasing tax rates of higher income individuals would be unfair because many of them incurred the greatest increase in individual tax burdens under the base-broadening provisions of the 1986 Act.

5. Selective increases in other taxes, primarily various excise taxes, would make it possible to tax consumer spending that would not be discouraged by higher taxes, and to adjust excise tax rates to levels that would be perceived as more appropriate than present rates.

6. Individual income and social insurance tax payments make up more than three-fourths of budget receipts. Using other tax sources to raise revenues for budget reduction would provide greater balance and diversification of revenue sources.

7. With respect to temporary surtax proposals, many individuals and corporations would not believe that the increase would not be extended indefinitely.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Individual and corporate tax rates and surtaxes:				
a. 5-percent individual surtax	10.3	20.1	22.6	53.0
b. 5-percent corporate surtax	3.6	6.3	7.0	16.9
c. 5-percent individual surtax on tax over $10,000	3.1	6.2	7.4	16.7
d. 5-percent corporate surtax on tax over $10,000	3.3	5.9	6.4	15.7
e. Freeze 1987 rate schedule:				
(1) One year (individual)	9.0	7.4	....	16.4
(2) One year (corporate)	8.2	5.5	....	13.7
(3) Permanent freeze with indexing (individual)	9.0	18.8	23.0	50.9
f. Impose 33-percent rate on income levels above phaseout of personal exemptions	2.8	6.5	8.8	18.2
g. 38.5-percent top rate above $225,000 of income (for joint returns), with 33-percent intermediate rate; 28-percent gains rate	4.7	9.9	12.3	26.9

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2. Reduction in Individual and Corporate Tax Preferences

Present Law

A number of provisions in the income tax law and regulations provide economic incentives to the private sector or tax relief to particular kinds of taxpayers. These tax provisions, often referred to as preferences, generally take the form of exclusions, credits, deductions, and deferrals of tax liability.

Preferences make possible the reduction of tax liability in relation to economic income. In some cases, the amount of tax reduction that can be accomplished through the use of preferences is limited by the alternative minimum tax. However, the minimum tax does not apply to all items that could be considered preferences, and applies to some preferences only in part. Moreover, even preferences that are fully subject to the minimum tax can be used by taxpayers to reduce tax liability, because the minimum tax rate is lower than the regular tax rate.

Under present law, corporate tax preferences relating to percentage depletion for coal and iron ore, excess bad debt reserves of banks, interest to acquire certain previously acquired tax-exempt bonds, FSC income, amortization of pollution control facilities, mining development and exploration expenditures, and intangible drilling costs of integrated oil companies are subject to an across-the-board cutback ranging from 20 to 30 percent.

Possible Proposals

1. The value of tax preferences could be directly reduced by a specified percentage. Such reductions in the value of preferences would apply to all taxpayers for regular tax purposes and, for preferences currently allowed in computing minimum tax, for minimum tax purposes.

This approach involves reducing by a percentage the gross amount of items such as exclusions, deductions that permit the permanent understatement of income (rather than the deferral of tax liability), and credits. With respect to items that permit the deferral of tax liability, the approach would involve permitting such deferral only with respect to a percentage of the item involved. For example, if applied to accelerated depreciation, the approach would involve requiring a portion of basis to be deducted more slowly, rather than permanent disallowance of a portion of depreciation deductions.

Preferences that could be reduced include the credits for child and dependent care expenses, clinical testing expenses, and producing fuel from nonconventional sources; the investment tax credit; the targeted jobs tax credit; the alcohol fuels tax credit; the research credit; and the possessions tax credit. The reduction could apply to itemized deductions for individuals, deductions for ACRS, pollution control facility amortization, circulation expenditures, research and experimental expenditures, expenses for tertiary injectants, excess percentage depletion, intangible drilling costs, mining exploration and development expenses, business entertainment deductions, foreign convention attendance expenses, certain travel expenses, financial institution preferences, soil and water conservation expenditures, and the small life insurance company deduction.

The benefits of incentive stock options, foreign sales corporations, deferral for foreign controlled corporations, tax exemption for credit unions, certain ESOP loans, lump-sum averaging, sales to ESOPs, and shipping income deferral also could be reduced. Also, the dollar limitations for the one-time housing gain exclusion, the foreign earned income exclusion, the expensing of depreciable property, amortization of reforestation expenditures, IRA deductions, employee gifts, luxury cars, and pension plan benefits and contributions could be reduced. The tax-exempt bond ceilings could be lowered. In addition, the alternative minimum tax rate also could be increased.

2. The present law corporate cutbacks in section 291 could be increased by a set percentage.

Pros and Cons

Arguments for the proposals

1. In periods of large budget deficits, across-the-board reductions in tax preferences are appropriate.

2. The taxpayers affected by the proposals generally would be those paying relatively less tax in relation to economic income.

3. The proposals could be designed to have a relatively uniform effect on preferences, and thus not to have a disproportionate effect on particular taxpayers or tax preference items.

Arguments against the proposals

1. The proposals could reduce the value of preferences that it was considered desirable to retain in full.

2. The proposals could increase the complexity of the income tax system, by requiring additional mathematical computations.

3. The tax preferences that would be reduced were enacted or retained in the Internal Revenue Code of 1986 to accomplish some social or economic purpose. These goals could be undermined by a reduction in the preferences.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Across-the-board reduction in individual tax preferences (10 percent for itemized deductions; 20 percent for certain credits and preferences)	1.2	11.4	11.8	24.4

3. Individual Income Tax Provisions

a. Credit for child and dependent care expenses

Present Law

Present law provides a tax credit equal to up to 30 percent of certain employment-related child and dependent care expenses. For example, expenses of a day care center or home infant care are eligible for the credit if incurred to enable the taxpayer to work. The amount of such expenses eligible for the credit is limited to $2,400 ($4,800 for the care of two or more individuals).

The 30-percent credit rate is reduced by one percentage point for each $2,000 (or portion thereof) of adjusted gross income (AGI) between $10,000 and $28,000. The credit rate is 20 percent for individuals with AGI exceeding $28,000.

Possible Proposals

1. The credit rate could be reduced by one percentage point for each $2,000 (or portion thereof) by which AGI exceeds $50,000. Under this proposal, no credit would be allowed to taxpayers with AGI exceeding $88,000.

2. Expenses of overnight camps could be made ineligible for the credit.

Pros and Cons

Arguments for the proposals

1. Under present law, the child care credit may be claimed by high-income individuals who do not need Federal tax subsidies for their child care expenses.

2. In many cases, high-income individuals claim a credit for expenses that would be incurred regardless of whether both spouses are working outside the home, e.g., nursery school, housekeeper, and summer camp costs.

3. In the case of a parent's expenditures to send a child to an overnight camp (such as a summer camp in a vacation area), the personal element of the expenditure predominates over any income-producing connection. Accordingly, tax subsidies should not be given for the costs of sending a child away from home to camp merely because the child's parent or parents work outside the home.

Arguments against the proposals

1. To the extent that child care expenses incurred to enable the taxpayer to work represent expenses of earning income, the tax treatment of such expenses should be the same for all eligible taxpayers regardless of income level.

2. Middle-income two-earner couples lost various deductions as a result of the 1986 Act, such as the two-earner deduction and IRAs. To disallow the child care credit in addition would be perceived as unfair.

3. There is no reason to allow the credit for costs of a child's attending a day camp while not in school but to deny it merely because the child attends an overnight camp, since both types of expenditures enable the child's parent or parents to work outside the home.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
Phaseout credit for AGI over $50,000		0.3	0.4	0.7
Deny credit for overnight camp expenditures	(1)	0.1	0.1	0.1

[1] Gain of less than $50 million.

b. Interest expense deduction on home equity loans

Present Law

Under present law, as amended by the 1986 Act, the itemized deduction for personal interest is being phased out over the period 1987-1990. Personal interest is any interest, other than interest incurred or continued in connection with the conduct of a trade or business (other than the trade or business of performing services as an employee), investment interest, or interest taken into account in computing the taxpayer's income or loss from passive activities for the year. These rules are phased-in and become fully effective in 1991.

Present law provides that qualified residence interest is not subject to the limitation on personal interest. Qualified residence interest is interest on debt secured by a security interest valid against a subsequent purchaser on the taxpayer's principal residence or a second residence of the taxpayer. Interest on such debt is generally deductible to the extent that the debt does not exceed the amount of the taxpayer's basis for the residence (including the cost of home improvements). Present law also allows a taxpayer to deduct as qualified residence interest the interest on certain loans incurred for educational or medical expenses up to the fair market value of the residence. A grandfather rule treats interest on debt incurred on or before August 16, 1986 and secured by the taxpayer's principal or second residence as qualified residence interest, provided the amount of the debt does not exceed the fair market value of the residence.

Thus, under present law, a taxpayer may deduct interest on a loan secured by a lien on his or her residence, up to the amount of the original cost of the residence (plus improvements), even though the loan proceeds are used for personal purposes. These loans are being advertised by lending institutions as "home equity loans".

In computing an individual's alternative minimum tax under present law, personal interest is deductible only if that interest is on a loan which was incurred in acquiring, constructing, or substantially rehabilitating a taxpayer's residence. Thus, interest on "home equity loans" not used for such purposes is not deductible in computing the minimum tax.

Possible Proposals

1. The rule currently applicable under the minimum tax limiting the deduction for interest on a qualified residence loan to interest incurred in connection with a loan to acquire, construct, or rehabilitate a taxpayer's principal or second residence could be adopted for purposes of the regular tax.

2. The interest deduction for home equity loans for noneducational, nonmedical purposes could be limited to $10,000 per year.

3. Interest on home equity loans without a fixed term could be made nondeductible.

4. The amount of debt eligible for the qualified residence exception could be limited to $1 million.

5. It could be clarified that boats and mobile homes are ineligible to qualify as second residences for purposes of the interest expense deduction.

Pros and Cons

Arguments for the proposals

1. The proposals would tend to limit the interest deductions to situations where the incentive would directly encourage home ownership.

2. Present law discriminates against persons who have no equity in their homes against which to borrow when personal indebtedness is incurred. These proposals would treat all taxpayers more nearly equally with respect to these personal loans.

3. The proposals would carry out the intention of Congress to prevent deduction of interest on debt used to acquire consumer goods which do not give rise to taxable income.

4. Present law encourages persons to give lenders a lien on their residence for consumer debt, which could cause loss of the residence in the case of nonpayment of the loan. These proposals would take away that encouragement.

Arguments against the proposals

1. The proposals might encourage homeowners to make low down payments and arrange loans with small or no principal payments in order to maximize interest deductions. There is no sound public policy reason for encouraging taxpayers to do so.

2. The proposals would encourage individuals to borrow more than they really need to purchase a house in anticipation of future needs for funds.

3. The proposals could make borrowing for educational and medical purposes more costly.

4. The proposals may be contrary to the policy of allowing some level of deductibility of personal interest in the case of homeowners.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Interest expense deduction on home equity loans:				
Limit to acquisition indebtedness	0.2	1.7	1.8	3.8
$10,000 limit (other than education and medical)	(1)	0.3	0.3	0.6
$1 million cap	(1)	0.3	0.3	0.6
Boats and mobile homes ineligible as second residences	(1)	(1)	(1)	(1)

1 Gain of less than $50 million.

c. Other itemized deductions

(1) Disallowance of deduction for nonbusiness personal property taxes

Present Law

Under present law, itemizers may deduct three types of State and local taxes whether or not incurred in a trade or business or in an investment activity—individual income taxes, real property taxes, and personal property taxes. (State and local sales taxes were made nondeductible under the Tax Reform Act of 1986, beginning in 1987.)

In general, personal property taxes on nonbusiness property are deductible only if imposed (1) on an annual basis, and (2) substantially in proportion to the value of the personal property that is subject to tax. (For example, itemized deductions are allowed for personal property taxes imposed, in some States, on automobiles, motorcycles, and boats used for personal purposes.) A tax on personal property that is based in part on criteria other than the value of the property, or that is collected either more or less frequently than once per year, may qualify for deductibility, as may a tax imposed in the form of a privilege. For example, vehicle registration fees based partly on value and partly on other criteria (such as weight) may be deductible in part.

At present, some 26 States (or their subdivisions) impose taxes on one or more types of tangible personal property not used for business or investment purposes, such as boats or automobiles used for personal purposes.

Possible Proposal

The itemized deduction for personal property taxes that are not incurred in a trade or business or in an investment activity could be repealed. (The May 1985 tax reform proposals of President Reagan called for disallowing itemized deductions for all nonbusiness taxes, including nonbusiness personal property taxes.)

Pros and Cons

Arguments for the proposal

1. Personal property taxes that are not incurred in a trade or business or in an investment activity—for example, such taxes imposed on personal vehicles or boats—are expenditures of a personal or consumption nature. Personal expenditures generally are not deductible in light of tax policies that deductions should be allowed only for expenditures essential to earning income, and that personal consumption should not be subsidized through the tax system.

2. Deductions for State and local personal property taxes benefit only those taxpayers with a narrow range of consumption patterns (in contrast to State and local income taxes) and do not benefit home ownership (in contrast to State and local real property taxes). Less than one-third of returns filed by itemizers for 1983 claimed deductions for nonbusiness personal property taxes.

Arguments against the proposal

1. The deduction disallowance could adversely affect the ability of State and local governments to utilize personal property taxes in meeting their revenue needs.

2. The deduction disallowance would result in more favorable treatment to itemizers living in States that impose only real property or income taxes than to taxpayers in States that rely in part on personal property taxes to meet their revenue needs.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
Disallow deduction for nonbusiness personal property tax	0.1	0.4	0.4	0.9

(2) *Imposition of floor under aggregate itemized deductions for higher-income taxpayers*

Present Law

Individuals may elect to itemize their allowable deductions for certain personal expenditures if the total of itemizable deductions exceeds the applicable standard deduction amount. Under present law, there is no other overall limitation imposed on the allowance of itemized deductions.

However, present law imposes floors under certain of the itemized deductions. Medical expenses may be deducted only to the extent exceeding 7.5 percent of the taxpayer's adjusted gross income (AGI). Casualty and theft losses greater in amount than $100 each may be deducted only to the extent that the sum of all such losses (net of related gains) exceeds 10 percent of AGI. Miscellaneous itemized deductions generally are allowed only to the extent the total amount exceeds two percent of AGI.

Possible Proposal

A floor equal to 10 percent of the taxpayer's adjusted gross income in excess of $100,000 ($50,000 for a single individual) could be placed under the total amount of the taxpayer's itemized deductions. For example, if married individuals with AGI of $210,000 had total itemizable deductions (allowable after taking into account the present-law specific floors) of $28,000, their allowable itemized deductions would be reduced to $17,000.

Pros and Cons

Arguments for the proposal

1. Most itemized deductions represent expenses incurred for personal consumption or financial purposes, and are not related to costs of earning income in a trade or business. Accordingly, limiting the aggregate amount of itemized deductions is consistent with the general tax policy that deductions should be allowed only for expenditures essential to earn income, and that personal consumption should not be subsidized through the tax system.

2. The proposed floor under aggregate itemized deductions also would be consistent with the policy (reflected in the specific floors under certain itemized deductions) that deductions for personal expenditures should be limited to involuntary and unusually large expenditures that may exhaust a large proportion of the taxpayer's total income for a particular year, thereby significantly affecting his or her ability to pay taxes. Since the proposal would impose a floor under, but not a ceiling on, itemized deductions, the taxpayer still could deduct amounts of expenses or losses that could be catastrophic relative to the taxpayer's income and ability to pay taxes.

3. By reducing the number of taxpayers who itemize, rather than using the standard deduction, the proposed floor would contribute to tax simplification and reduce recordkeeping, verification, and audit burdens on taxpayers and the IRS. The allowance of itemized deductions has long been recognized as a primary cause of complexity for individual taxpayers, particularly since intricate rules and limitations apply in determining eligibility for, and in computing, most itemized deductions.

Arguments against the proposal

1. The largest itemized deductions for most taxpayers are home mortgage interest and State and local income and real property taxes. Limitations placed on these deductions would contravene long-standing tax policies with respect to home ownership and comity with State and local governments.

2. There is no rationale for imposing an overall floor in addition to the specific floors that already place significant limitations on the deductibility of medical expenses, casualty and theft losses, and certain miscellaneous itemized deductions.

3. If an overall floor reflects appropriate tax policy, the floor should apply to all itemizers, including those with AGI below $100,000/$50,000. Further, a more equitable and straightforward way to impose a higher effective tax rate on individuals with AGI above a specified level would be through adjustments to the rate structure.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
Floor under aggregate itemized deductions of 10 percent of AGI over $50,000 ($100,000 for joint returns)	1.0	7.2	8.7	16.9

(3) Limitation on tax-liability reduction for top-bracket individuals

Present Law

Under present law, the allowance of itemized deductions provides a greater tax benefit for such expenditures of a personal or consumption nature to higher-bracket taxpayers than to lower-bracket taxpayers. For example, itemized deductions of $10,000 in 1988 will reduce the tax liability of an individual in the 15-percent bracket by $1,500, but will reduce the tax liability of an individual in the 28-percent bracket by $2,800.

Possible Proposal

The deduction for itemized deductions could be allowed only against the lowest (15 percent) tax rate. Alternatively, the deduction could be converted into a 15-percent tax credit.

Pros and Cons

Argument for the proposal

All taxpayers would receive the same tax benefit from the same dollar amount of itemized deductions. This would eliminate the greater proportionate benefits that higher-income taxpayers receive under present law, so that charitable contributions (for example) would receive the same tax subsidy regardless of the income level of the donor.

Arguments against the proposal

1. The proposal would conflict with the rationales and objectives for allowing itemized deductions, such as the encouragement of home ownership and charitable giving and the proper measurement of the ability to pay taxes, and would affect adversely the ability of State and local governments to raise needed tax revenues.

2. The proposal would add further complexity to tax computations for itemizers; also, taxpayers would have difficulty understanding the reason for changing the basic structure of the itemized deductions.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
Limit itemized deductions to 15 percent tax bracket	3.4	22.7	24.7	50.7

4. Business Meal and Entertainment Expenses

Present Law

Meal and entertainment expenses incurred for business or investment reasons are deductible if certain legal and substantiation requirements are met. The amount of the deduction generally is limited to 80 percent of the expense that meets these requirements.

Possible Proposal

The percentage of otherwise allowable meal and entertainment expenses that is deductible could be reduced, for example, from 80 percent to 75 percent or 50 percent.

Pros and Cons

Arguments for the proposal

1. Meal and entertainment expenses have a personal consumption element even when they serve a legitimate business purpose and are not excessive. This personal consumption element justifies disallowing more than 20 percent of the deduction.

2. Deductions for meal and entertainment expenses involve many abuses, such as excessive expenditures and deductions for expenditures that were not truly business-motivated. In view of the difficulty, from an administrative and enforcement standpoint, of preventing these abuses, overall deductions should be restricted further.

Arguments against the proposal

1. In many circumstances, meal and entertainment deductions represent legitimate business expenses that should not be limited further.

2. Taxpayers who claim legitimate deductions should not be penalized because of abuses by other taxpayers.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
a. Allow 75% deductibility	0.2	0.5	0.6	1.3
b. Allow 50% deductibility	1.3	2.4	2.8	6.6

5. Employee Benefits; Pensions; ESOPs

a. Employee benefits

(1) Limit the exclusion of employer-provided health coverage

Present Law

In general, employer-provided health coverage is excludable from an employee's income. The exclusion is conditioned, however, on the coverage being provided under a plan meeting certain nondiscrimination and qualification requirements.

Employer-provided health coverage is unconditionally excludable from wages for purposes of the FICA and FUTA taxes.

Possible Proposals

1. In the Treasury Department Report to the President issued in November of 1984, Treasury proposed that employer contributions to a health plan be included in an employee's income to the extent that they exceed $70 per month ($840 per year) for individual coverage of an employee, or $175 per month ($2,100 per year) for family coverage (i.e., coverage that includes, in addition to the employee, the spouse or a dependent of the employee). The dollar limits were to be adjusted annually to reflect changes in the Consumer Price Index.

These limits, which could be set at higher amounts, would apply for FICA and FUTA purposes as well as income tax purposes.

2. The President's tax reform proposal of May 1985 proposed requiring employer contributions to a health plan to be included in an employee's income up to $10 per month for individual coverage or $25 per month for family coverage.

3. The cap on excludable health benefits could be applied only for FICA and FUTA purposes.

4. The exclusion of employer-provided health coverage from wages for FICA and FUTA purposes could be repealed.

Pros and Cons

Arguments for the proposals

1. The exclusion from income and wages of employer-provided health coverage can result in taxpayers with the same economic income paying different amounts of tax because of the form in which their compensation is received. The exclusion from income and wages also narrows the tax base, either causing higher tax rates or reducing needed revenues.

2. The exclusion from income favors taxpayers in a higher tax bracket over taxpayers in a lower tax bracket, because the higher the bracket, the more valuable the exclusion. Moreover, the rules

establishing the exclusion are structured to permit larger exclusions for highly compensated employees, increasing the bias in favor of high-bracket taxpayers.

3. The exclusion from income and wages has encouraged unnecessarily generous health coverage that leads to overutilization of health services and higher costs for such services.

4. The policy objective of encouraging the provision of health coverage to low- and middle-income employees justifies the exclusion from income and wages only up to a point. A cap on the exclusion for health benefits is justified because, when the employer-provided coverage is too expensive, the costs and inequities described above of excluding the excessive portion of the benefit outweigh the marginal benefit of encouraging the provision of the corresponding amount of supplementary health coverage.

5. Inclusion of all or excess employer-provided health coverage in wages for FICA purposes would allow low- and middle-income employees to earn credit toward social security benefits by virtue of compensation received in the form of health coverage. As a result, lower income employees would not be forced (in the case of a contributory health plan that is voluntary) to choose between current health insurance coverage and future social security benefits.

Arguments against the proposals

1. The full exclusion from income and wages of employer-provided health coverage, to the extent conditioned on effective nondiscrimination rules prohibiting the plan from favoring highly compensated employees, is justified, as a matter of social policy, by the fact that such exclusion encourages the provision of needed health coverage to low- and middle-income employees who otherwise might not purchase such coverage.

2. If any of the proposals were enacted, employers would be less likely to provide adequate health coverage to low- and middle-income employees. In addition, many of such employees would not purchase adequate health coverage on their own. Accordingly, such employees may in some cases need public assistance. The cost of providing this assistance may well exceed the cost of retaining the present-law exclusion of employer-provided health coverage from income and wages.

3. If a limitation is based on a flat dollar amount of employer contributions (rather than, for example, on a value concept based solely on the health coverage features), it would discriminate against employers (and their employees) that have higher per employee costs for the same health coverage. Examples of such employers are (1) small employers, (2) employers in high cost regions, and (3) employers with older workforces.

4. The determinations of whether the limits on health coverage have been exceeded will be administratively burdensome for employers and the IRS.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
(1) Cap exclusion ($840/$2,100 per year)	3.3	6.0	7.5	16.8
(2) Floor on exclusion ($120/$300 per year	2.8	4.2	4.6	11.6
(3) Cap exclusion for FICA and FUTA only $840/$2,100 per year)	1.2	2.1	2.6	5.9
(4) Repeal exclusion for FICA and FUTA only	9.1	14.6	16.7	40.4

(2) Repeal the exclusion of employer-provided group-term life insurance

Present Law

In general, employer-provided group-term life insurance is excludable from an employee's income. The exclusion is conditioned, however, on the insurance being provided under a plan meeting certain nondiscrimination and qualification requirements. In addition, the exclusion does not apply to coverage in excess of $50,000.

Employer-provided group-term life insurance is unconditionally excludable from wages for purpose of the FICA and FUTA taxes.

Possible Proposals

1. In the Treasury Department Report to the President issued in November of 1984, Treasury proposed that the exclusion from income of employer-provided group-term life insurance be repealed. The repeal also could apply to the exclusion of employer-provided group-term life insurance from wages for FICA and FUTA purposes.

2. The exclusion from wages for FICA and FUTA purposes of employer-provided group-term life insurance could be repealed.

Pros and Cons

Arguments for the proposals

1. The exclusion of employer-provided group-term life insurance from income and wages can result in taxpayers with the same economic income paying different amounts of tax because of the form in which their compensation is received. In addition, the exclusion from income and wages also narrows the tax base, thereby requiring higher tax rates to produce a given amount of revenues.

2. The exclusion from income favors taxpayers in a higher tax bracket over taxpayers in a lower tax bracket, because the higher the bracket, the more valuable the exclusion. Moreover, the rules establishing the exclusion are structured to permit larger exclusions for highly compensated employees, increasing the bias in favor of high-bracket taxpayers.

3. The costs and inequities of the exclusion, described above, outweigh the marginal beneficial effect of the exclusion.

4. The proposal would allow low- and middle-income employees to earn credit toward social security benefits by virtue of compensation received in the form of group-term life insurance.

5. Because death benefits (as well as the value of up to $50,000 coverage) from group-term life insurance are tax free while benefits in excess of $5,000 from self-insured arrangements are taxable, present law favors the provision of death benefits through life in-

surance companies over self-insured arrangements through the income exclusion for group-term life insurance.

Arguments against the proposal

1. The exclusion from income and wages of employer-provided group-term life insurance, to the extent conditioned on effective nondiscrimination rules prohibiting the favoring of highly compensated employees, is justified, as a matter of social policy, by the fact that such exclusion encourages the provision of the insurance to low- and middle-income employees who otherwise might not purchase such insurance.

2. If any of the proposals were enacted, employers would be less likely to provide group-term life insurance to low- and middle-income employees. In addition, many of such employees would not purchase life insurance on their own. Accordingly, their survivors may in some cases need public assistance, because social security survivor benefits often are inadequate. The cost of providing this assistance may well exceed the cost of retaining the present-law exclusion of employer-provided group-term life insurance from income and wages.

3. The limit on the exclusion of employer-provided group-term life insurance from income is sufficiently low to ensure that it cannot be used to provide unnecessarily generous protection.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
(1) Repeal exclusion	2.0	3.1	3.2	8.4
(2) Repeal exclusion for FICA and FUTA only	0.8	1.3	1.3	3.4

(3) Repeal the $5,000 exclusion for employer-provided death benefits

Present Law

Death benefits paid by an employer to the estate or beneficiaries of a deceased employee generally are excluded from the recipient's income. The maximum amount, however, that may be excluded from income with respect to any employee is $5,000.

Possible Proposal

In the Treasury Department Report to the President issued in November of 1984, and the President's tax reform proposal of May 1985, it was proposed that the $5,000 exclusion from income of employer-provided death benefits be repealed.

Pros and Cons

Arguments for the proposal

1. The exclusion of employer-provided death benefits from income can result in taxpayers with the same economic income paying different amounts of tax because of the form in which their income is received. In addition, the exclusion from income also narrows the tax base, thereby requiring higher tax rates to produce a given amount of revenue.
2. The exclusion from income favors taxpayers in a higher tax bracket over taxpayers in a lower tax bracket, because the higher the bracket, the more valuable the exclusion. Moreover, the rules establishing the exclusion would permit the employer to provide the benefit only for highly compensated employees, exacerbating the problem that high-bracket taxpayers are favored.
3. The costs and inequities of the exclusion, described above, outweigh the marginal beneficial effect of the exclusion.

Arguments against the proposal

1. The exclusion from income of employer-provided death benefits is justified, as a social policy, by the fact that such exclusion encourages the provision of the death benefits with respect to low- and middle-income employees who otherwise might not purchase life insurance.
2. If the proposal were enacted, employers would be less likely to provide death benefits to low- and middle-income employees. In addition, many of these lower income employees would not purchase life insurance on their own. Accordingly, their survivors may in some cases need public assistance, because social security survivor benefits often are inadequate. The cost of providing this assistance may well exceed the cost of retaining the present-law exclusion of employer-provided death benefits from income.

3. The limit on the exclusion of employer-provided death benefits from income is sufficiently low to ensure that it cannot be used to provide unnecessarily generous benefits.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
Employer-provided death benefits	([1])	([1])	([1])	0.1

[1] Gain of less than $50 million.

(4) Repeal the exclusion of employer-provided dependent care assistance

Present Law

In general, employer-provided dependent care assistance is excludable from an employee's income. The exclusion is conditioned, however, on the assistance being provided under a plan meeting certain nondiscrimination and qualification requirements. In addition, the exclusion is limited to $5,000 in a taxable year ($2,500 in the case of a separate return by a married individual).

Employer-provided dependent care assistance is excludable from wages for FICA and FUTA purposes if, at the time the assistance is provided, it is reasonable to assume the assistance will be excludable from income.

Dependent care expenses (defined in the same manner as with respect to the exclusion) paid for by an individual are eligible for a nonrefundable credit against income tax liability of up to 30 percent (phasing down to 20 percent for higher income taxpayers). For this purpose, dependent care expenses are limited to $2,400, if there is one dependent, and $4,800, if there are two or more dependents.

Possible Proposals

1. In the Treasury Department Report to the President issued in November of 1984, Treasury proposed that the exclusion from income of employer-provided dependent care assistance be repealed. The repeal also could apply to the exclusion of employer-provided dependent care assistance from wages for FICA and FUTA purposes.

Employer-provided dependent care assistance would be eligible for the dependent care credit.

2. The exclusion from wages for FICA and FUTA purposes of employer-provided dependent care assistance could be repealed.

Pros and Cons

Arguments for the proposals

1. The exclusion of employer-provided dependent care assistance from income and wages can result in taxpayers with the same economic income paying different amounts of tax because of the form in which their compensation is received. The exclusion from income and wages also narrows the tax base, thereby requiring higher tax rates to produce a given amount of revenue.

2. The exclusion from income favors taxpayers in a higher tax bracket over taxpayers in a lower tax bracket, because the higher the bracket, the more valuable the exclusion. This is contrary to the policy explicit in the structure of the dependent care credit.

Moreover, the rules establishing the exclusion are structured to permit larger exclusions for highly compensated employees, increasing the bias in favor of high-bracket taxpayers.

3. Because the dependent care credit (to the extent available) is more advantageous for low-income employees, the exclusion largely functions to enable high-income taxpayers to obtain a larger tax benefit than they would otherwise obtain under the dependent care credit.

4. The costs and inequities of the exclusion, described above, generally outweigh the marginal beneficial effect of the exclusion.

5. It is inequitable to permit employees receiving employer-provided benefits to be exempt from FICA while individuals who pay for dependent care themselves are required to pay FICA on the wages used to purchase this care. The proposals would allow low- and middle-income employees to earn credit toward social security benefits by virtue of compensation received in the form of dependent care assistance.

Arguments against the proposal

1. The exclusion from income and wages of employer-provided dependent care assistance, to the extent conditioned on effective nondiscrimination rules prohibiting the favoring of highly compensated employees, is justified, as a matter of social policy, by the fact that the exclusion encourages the provision of the assistance to low- and middle-income employees who otherwise might not purchase the dependent care or, at least, not the same quality of dependent care.

2. If a taxpayer's dependent care expenses exceed the amount eligible for the credit, the exclusion will be advantageous regardless of income level. In addition, there are a significant number of middle-income taxpayers for whom the exclusion is more beneficial than the credit. Thus, retaining the exclusion is justified as a matter of social policy.

3. The social policies served by encouraging the provision of dependent care by employers include: (1) enabling many individuals to return to work who otherwise could not afford to; (2) increasing worker productivity to the extent that the worker need not be concerned during the workday with dependent care; and (3) increasing the quality of care provided to children of working parents.

4. Valuing dependent care assistance for inclusion purposes would impose a substantial administrative burden on employers and on the IRS.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
(1) Repeal exclusion	(1)	0.1	0.1	0.2
(2) Repeal exclusion for FICA and FUTA only	(1)	(1)	(1)	0.1

[1] Gain of less than $50 million.

(5) *Repeal the exclusions for employee benefits with respect to high-income employees*

Present Law

In general, employer-provided health coverage, group-term life insurance, and dependent care assistance are excludable from an employee's income. These exclusions are conditioned, however, on the benefits being provided under a plan meeting certain nondiscrimination and qualification requirements. In addition, the exclusion of group-term life insurance does not apply to coverage in excess of $50,000. The dependent care exclusion is limited to $5,000 in a taxable year ($2,500 in the case of a separate return by a married individual).

Employer-provided health coverage and group-term life insurance are unconditionally excludable from wages for purposes of the FICA and FUTA taxes. Employer-provided dependent care assistance is excludable from wages for FICA and FUTA purposes if, at the time the assistance is provided, it is reasonable to assume that the assistance will be excludable from income.

Possible Proposal

The exclusion from income and wages of employer-provided health coverage, group-term life insurance, and dependent care could be repealed for taxpayers (or employees) with adjusted gross income (or compensation) equal to or exceeding $60,000. The exclusions could be phased out between $50,000 and $60,000. In conjunction with this proposal, the applicable nondiscrimination rules could be repealed with respect to such benefits.

Pros and Cons

Arguments for the proposal

1. The exclusions of employee benefits from income and wages can result in taxpayers with the same economic income paying different amounts of tax because of the form in which their compensation is received. The exclusions from income and wages also narrow the tax base, thereby requiring higher tax rates to produce a given amount of revenue.

2. The justification for the exclusions is that they are intended to encourage the provision of the benefits by employers to low- and middle-income employees who otherwise might not purchase such benefits. The rationale for excluding the benefits from the income and wages of high-income employees is that, if the exclusions did not apply to high-income employees, employers would not adopt the employee benefit plans. In fact, for the vast majority of employers, the provision of employee benefits, especially health coverage, is necessary from an employee relations perspective. Thus, denying

the exclusions to the high-income employees generally will not affect employers' willingness to maintain such plans.

3. High-income employees do not need what is, in effect, a government subsidy (provided through the tax system) to purchase benefits. There are many examples of tax benefits that are not available to high-income taxpayers or are available on a more restrictive basis (e.g., IRAs, dependent care credit, elderly credit, earned income credit).

4. Repealing the nondiscrimination rules applicable to the specified employee benefits would simplify the law.

Arguments against the proposal

1. If the exclusions are not available with respect to high-income employees, employers will not maintain employee benefit plans and thus low- and middle-income employees will not receive the benefits.

2. In the case of a small or medium size employer, the employer's willingness to make benefits available generally to lower-income employees will be influenced to a great extent by the availability of an exclusion for higher-income employees. This is particularly true given the administrative cost to the employer of maintaining employee benefit plans.

3. High-income taxpayers have the same need for health coverage, life insurance, and dependent care as low- and middle-income taxpayers. Moreover, if such benefits are not provided to them by their employer (due to the repeal of the exclusions), such high-income taxpayers may not purchase such benefits on their own.

4. Phasing in an income inclusion as a taxpayer's income (or compensation) rises has the effect of increasing the taxpayer's marginal tax rate within the phase-in range.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
Repeal exclusion for employee benefits with respect to high-income employees	1.1	1.8	2.0	4.8

(6) Limit the exclusion for cafeteria plan benefits

Present Law

Under present law, compensation generally is taxable to employees when actually or constructively received. An amount is constructively received by a taxpayer if it is made available to the taxpayer.

There are various exceptions to this basic principle of constructive receipt. Under one exception, no amount is included in the income of a participant in a cafeteria plan meeting certain requirements solely because, under the plan, a taxable benefit is available to the participant. Nontaxable benefits that may be available under a cafeteria plan include, for example, health coverage, group-term life insurance, and dependent care assistance. The cafeteria plan exception from the principles of constructive receipt generally also applies for purposes of FICA and FUTA taxes.

Under another exception, an employee is not required to include in income employer contributions to a qualified cash or deferred arrangement merely because the employee could have elected to receive the amount in cash. This exception to the constructive receipt principle is limited to $7,000 in an employee's taxable year. In addition, this exception does not apply for FICA and FUTA purposes, even if the qualified cash or deferred arrangement is part of a cafeteria plan.

Possible Proposals

1. The cafeteria plan exception to the constructive receipt principle could be limited to a certain dollar amount, such as $500, for purposes of income, FICA, and FUTA taxes. As under present law, a plan offering an employee a choice only among nontaxable benefits would not be subject to this cap.
2. The cafeteria plan exception to the constructive receipt principle could be repealed for FICA and FUTA purposes.
3. A plan offering dependent care assistance could be considered ineligible for the cafeteria plan exception to the constructive receipt principle.

Pros and Cons

Arguments for the proposals

1. Limiting the constructive receipt exception for cafeteria plans to a certain dollar amount, such as $500, would serve purposes similar to those served by the $7,000 limit on elective deferrals under a qualified cash or deferred arrangement. Because elective arrangements can allow some of the most needy employees to elect cash instead of benefits without violating the applicable nondiscrimination rules, the current revenue cost of cafeteria plans is not

justified by the results. In addition, in some cases, the dollar limit will result in cafeteria plans functioning as supplements to nonelective employee benefit plans, rather than in lieu of such nonelective plans.

The dollar limit does not eliminate an employer's ability to allow different employees to choose different benefits. The dollar limit simply limits the tax benefits provided to such an arrangement.

2. Repealing the cafeteria plan exception to the constructive receipt principle for FICA and FUTA purposes would be consistent with the retirement plan area in which exceptions to the constructive receipt principle may reduce income, but not wages. The rationale for such a rule is that social security is intended to be a mandatory program; individuals generally should not be entitled to elect out of the program, even partially.

3. In general, low-income employees do not elect dependent care assistance under a cafeteria plan, since for them the dependent care credit (to the extent available) is more advantageous than the income exclusion for the assistance. Thus, allowing dependent care assistance to be elected under a cafeteria plan functions largely to enable high-income taxpayers to obtain a larger tax benefit for their housekeepers and to avoid certain restrictions applicable to the dependent care credit. The applicable nondiscrimination rules do not prevent such favoring of high-income taxpayers.

4. A significant portion of the projected long-term deficit in the social security trust funds is attributable to the shrinking of the taxable wage base from the exclusion of fringe benefits for FICA purposes. As the portion of compensation paid in nontaxable fringe benefits grows, the size of the taxable payroll shrinks. By subjecting wages excluded from income under cafeteria plans to FICA tax, this shrinkage in the wage base would be slowed and the long-term financing of social security would be strengthened.

5. As pointed out in a study issued by the Department of Health and Human Services in July 1985, cafeteria plans can, under present law, have an adverse effect on efforts to contain health costs.

Arguments against the proposals

1. The proposed limitations on cafeteria plans would reduce their usage by employers and thus could result in some employees receiving benefits they do not need and others not receiving benefits they do need. Such a result may lead to an inefficient use of tax expenditures if employers provide employees with unnecessary benefits. The concern that low- and middle-income employees will take cash instead of benefits is adequately addressed by the nondiscrimination rules.

2. If one of the first two proposals were enacted, employers would be less likely to provide employee benefits to low- and middle-income employees. In addition, many of these lower-income employees would not purchase such benefits on their own. Accordingly, such employees may in some cases need public assistance. The cost of providing this assistance may well exceed the cost of retaining the present-law unlimited exclusion for cafeteria plans.

3. If a taxpayer's dependent care expenses exceed the amount eligible for the credit, it would be advantageous for such a taxpayer

to elect dependent care expenses under a cafeteria plan regardless of income level. In addition, there are a significant number of middle-income taxpayers for whom the exclusion is more beneficial than the credit. Retaining the availability of dependent care assistance under a cafeteria plan thus is justified as a matter of social policy.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
(1) Cap cash option under a cafeteria plan ($500 per year)	0.8	1.4	1.9	4.1
(2) Repeal cafeteria plan exception for FICA and FUTA only	0.6	1.2	1.7	3.5
(3) Disqualify dependent care assistance from cafeteria plan exception	(1)	0.1	0.1	0.2

1 Gain of less than $50 million.

(7) Exclusion from income for meals and lodging

Present Law

Under the Code, certain meals and lodging furnished to an employee for the convenience of the employer are excluded from the employee's gross income. At the same time, the employer may still deduct the costs of such employee benefits (subject to the 80-percent deduction limitation with respect to business meals).

Possible Proposals

1. The availability of this exclusion to corporate officers and significant shareholders could be restricted.
2. Employers could be denied a deduction for the direct operating costs of providing meals that are excludable from their employees' incomes on the grounds that they are furnished for the convenience of the employer. However, the employer could deduct such costs to the extent of reimbursements from the employees.

Pros and Cons

Arguments for the proposals

1. Corporate officers and significant shareholders can have significant influence over the corporation, which could effectively enable them to provide these tax benefits to themselves.
2. There is a significant tax subsidy with respect to meals provided for the convenience of the employer (since they are totally excludable from the employee's income), yet there is no compelling policy reason for the subsidy. This subsidy could be reduced by denying the deduction for providing such meals. Denying the deduction, rather than including the fair market value of the meals in income, avoids the problem that, in many cases under the particular circumstances under which a meal is furnished for the convenience of the employer, the fair market value of the meal may be difficult to determine.

Arguments against the proposals

1. Corporate officers and significant shareholders who are employees should be treated like other employees.
2. Limiting the exclusion would cause administrative difficulties for employers and the IRS in valuing appropriately meals and lodging furnished to an employee for the convenience of the employer.
3. The fact that a meal is not includible in an employee's income should not affect the deductibility to the employer of providing the meal if it is a legitimate business expense provided for the convenience of the employer.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
(1) Restrict exclusion for corporate officers and significant shareholders	[1]	[1]	[1]	[1]
(2) Restrict employer	0.2	0.3	0.3	0.9

[1] Gain of less than $50 million.

b. Pensions

(1) Treat loans from qualified plans as distributions

Present Law

Under present law, an individual is permitted to borrow from a qualified plan in which the individual participates (and to use his or her accrued benefit as security for the loan) provided certain requirements are satisfied.

In certain cases, a loan to a plan participant is treated as a taxable distribution of plan benefits. This rule of income inclusion does not apply to the extent that the loan (when added to the outstanding balance of all other loans to the participant from all plans maintained by the employer) does not exceed the lesser of (1) $50,000 (reduced by the excess (if any) of (a) the highest outstanding balance of all other loans from all plans of the employer during the 1-year period ending on the day before the date on which the loan is made, over (b) the outstanding balance of such loans on the date the loan is made), or (2) the greater of $10,000 or one-half of the participant's accrued benefit under the plan. This exception applies only if the loan is required, by its terms, to be repaid within 5 years or, if the loan is used to acquire the principal residence of the participant, within a reasonable period of time.

Possible Proposal

Treat any loan from a qualified plan as a distribution of plan benefits that is includible in income to the extent the distribution is not treated as a return of the employee's investment in the contract under the normal basis recovery rules.

Pros and Cons

Arguments for the proposal

1. The proposal would make the treatment of loans from qualified plans consistent with the treatment of loans from IRAs.

2. The proposal would increase the likelihood that retirement benefits will be held until retirement by discouraging withdrawals through loans.

3. Under present law, in the case of a contributory plan, employers often provide favorable loan provisions in order to induce higher levels of participation by nonhighly compensated employees. The proposal would force employers to provide additional incentives (such as higher employer matching contributions) and, therefore, should increase the total plan benefits provided to nonhighly compensated employees.

Arguments against the proposal

1. Often, an employee's retirement benefit is the employee's most significant source of savings. If loans from retirement plans are treated as taxable distributions, then an employee may not have a source of funds in the case of a medical or other emergency.

2. In the case of a contributory retirement plan, the absence of a favorable loan provision may discourage retirement saving and, therefore, reduce the aggregate amount that an employee has available for retirement income.

3. Unfavorable loan provisions treat an employee who participates in a pension plan less favorably than another borrower of plan assets.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Treat plan loans as distributions	([1])	0.1	0.1	0.2

[1] Gain of less than $50 million.

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(2) Redefine full funding limitation for pension plans

Present Law

Under present law, subject to annual limitations, an employer may make deductible contributions to a qualified defined benefit pension plan up to the full funding limitation. The full funding limitation is defined as the excess of (1) the accrued liability under the plan for projected benefits over (2) the plan assets. Projected benefits, unlike accrued benefits, are the benefits that are projected to be earned by normal retirement age, rather than the benefit accrued as of the close of the year.

If a defined benefit plan is terminated, the employer's liability to plan participants does not exceed the plan's termination liability (i.e., the liability for benefits determined as of the date of the plan termination). A plan's termination liability may be significantly less than the plan's full funding limitation.

Possible Proposal

The full funding limitation could be defined as a multiple of a plan's termination liability for deduction and minimum funding purposes. Thus, an employer would be permitted to make a deductible contribution to a defined benefit plan for a year to the extent that, after the contribution, the plan's assets do not exceed some percentage (e.g., 150 or 200 percent) of the plan's termination liability.

Pros and Cons

Arguments for the proposal

1. An employer's accrued liability to employees under a defined benefit plan at any point in time does not exceed its liability for benefits in the event of plan termination (i.e., termination liability). An employer should not be permitted to deduct contributions to a defined benefit plan for liabilities that have not yet been incurred by the plan if the plan assets significantly exceed this accrued liability. This rule would ensure that the deductibility of employer contributions to pension plans is treated more consistently with the deductibility of payments for other accrued liabilities.

2. Under present law, an employer may systematically overfund its pension plan to obtain the benefit of a current deduction and tax-free growth, (i.e., in order to use the pension plan as a tax-favored savings arrangement). The present-law 10-percent excise tax on plan reversions does not adequately deter this systematic overfunding.

Arguments against the proposal

1. The defined benefit plan funding and deduction rules were designed to encourage employers to fund for projected, rather than accrued, liabilities. A limitation on the employer's ability to deduct plan contributions may create a disincentive for funding.

2. Employers frequently adopt funding methods that permit the cost of an employee's retirement benefits to be funded as a level annual amount over the employee's working career rather than funded as an employee's benefits are accrued. The proposal would discourage the use of these level funding methods.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
Modify full funding limitation (150 percent rule)	0.6	1.8	1.4	3.9

(3) Definition of active participant for IRA rules

Present Law

Under present law, a taxpayer is permitted to make deductible IRA contributions up to the lesser of $2,000 or 100 percent of compensation (earned income, in the case of a self-employed individual) if the taxpayer (1) has adjusted gross income (AGI) that does not exceed an applicable dollar amount or (2) is not an active participant. In the case of a married couple filing a joint return, the AGI of the couple and the active participant status of either spouse is taken into account in determining whether a taxpayer may make deductible IRA contributions.

The term "active participant" means, with respect to any plan year, an individual who, for any part of the plan year ending with or within the taxable year, is an active participant in (1) a qualified plan (sec. 401(a) or 403(a)), (2) a plan established for its employees by the United States, by a State or political subdivision thereof, or by an agency or instrumentality of the United States or a State or political subdivision, (3) a tax-sheltered annuity (sec. 403(b)), or a simplified employee pension (SEP) (sec. 408(k)). In addition, an individual is considered an active participant if the individual makes deductible contributions to a plan described in section 501(c)(18).

In a recent Tax Court decision, it was held that Article III judges are not employees of the United States and, therefore, are not active participants in a plan established for its employees by the United States.[1] Whether or not an individual is an employee is also relevant for other purposes under the Code, such as for the exclusion of certain benefits from income and the eligibility for certain deductions.

Possible Proposal

The decision in *Porter v. Commissioner* could be overturned and officers of the United States or of a State or political subdivision as described in the decision could be treated as employees for purposes of the Code and as active participants for purposes of the IRA deduction limit.

Pros and Cons

Arguments for the proposal

1. The IRA deduction rules are designed to permit individuals who otherwise do not participate in a qualified pension plan to make deductible IRA contributions in order to accumulate tax-favored retirement income. This purpose is not served by a rule that

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[1] *Porter v. Commissioner*, 88 T.C. No. 28 (March 5, 1987).

fails to treat as employees individuals who are earning retirement benefits under an employer-maintained plan.

2. The active participant rules should treat consistently individuals who are covered under tax-favored retirement arrangements. Allowing certain individuals who perform services for the United States or for a State or political subdivision to participate in a tax-favored retirement plan and to make deductible IRA contributions does not promote this consistency of treatment.

3. The decision in *Porter v. Commissioner* has implications beyond the specific treatment of Article III judges for purposes of the active participant rules. Conceivably, the decision could be interpreted to permit high-level state and Federal officials to make deductible IRA contributions, while other individuals who do not perform services for governmental entities would be denied deductions for IRA contributions. Such a result would be perceived as inequitable. Similarly, the decision could be interpreted to deny an exclusion from income for certain benefits (such as health benefits) for the individuals subject to the decision.

Arguments against the proposal

1. Congress intended to treat only certain plans as employer-maintained pension plans for purposes of the active participant rules. The type of plan in which an Article III judge participates is not the type of plan intended to be covered by the active participant rules.

2. The proper interpretation of the scope of the decision in *Porter v. Commissioner* is best left to the courts.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
Modify active participant rules	[1]	[1]	[1]	[1]

[1] Gain of less than $50 million.

c. Repeal certain special rules relating to ESOPs

Present Law

Leveraged ESOPs

Under present law, an employee stock ownership plan (ESOP) is a qualified stock bonus plan, or a combination of a stock bonus and a money purchase pension plan, designed to invest primarily in qualifying employer securities.

Present law generally prohibits loans between a plan and a disqualified person. An exception to this rule is provided in the case of an ESOP. Thus, the employer securities held by an ESOP may be acquired through direct employer contributions or with the proceeds of a loan to the trust (or trusts) from the employer or guaranteed by the employer.

An ESOP that borrows to acquire employer stock is referred to as a leveraged ESOP. In some cases, a leveraged ESOP borrows from a financial institution the funds needed to purchase the stock and uses the proceeds to purchase the stock. Typically, the loan is guaranteed by the employer. The employer stock may be pledged as collateral (if the loan is nonrecourse and the only assets of the ESOP pledged are shares purchased with the loan proceeds).

Alternatively, the employer may borrow from a financial institution or other lender and sell its stock to the ESOP in exchange for the ESOP's installment note. Under this arrangement, the ESOP uses employer contributions to pay off the note to the employer who will, in turn, use those payments to repay its lender.

Interest exclusion for ESOP loans

Under present law, a bank, an insurance company, a corporation actively engaged in the business of lending money, or a regulated investment company may exclude from gross income 50 percent of the interest received with respect to a securities acquisition loan used to acquire employer securities. A securities acquisition loan generally is defined to include (1) a loan to a corporation or to an ESOP to the extent that the proceeds are used to acquire employer securities (within the meaning of sec. 409(l)) for the plan, or (2) a loan to a corporation to the extent that the corporation transfers an equivalent amount of employer securities to the plan.

Employer deductions for ESOP contributions

Under present law, the contributions of an employer to a qualified plan are deductible in the year for which the contributions are paid, within limits (sec. 404).

The deduction limits applicable to an employer's contribution depend on the type of plan to which the contribution is made and may depend on whether an employee covered by the plan is also covered by another plan of the employer.

In the case of an ESOP described in section 4975(e)(7), special deduction limits apply. Contributions to such an ESOP for a year are deductible to the extent they do not exceed the sum of (1) 25 percent of the compensation of the ESOP participants, in the case of principal payments on a loan incurred for the purpose of acquiring employer securities and (2) the amount of any interest repayment on such a loan.

Certain dividends paid on stock held in an ESOP are deductible to the extent the dividends are passed through to plan participants or used to repay a loan with which the stock was acquired.

Special contribution limits for ESOPs

Under present law, overall limits apply to contributions and benefits provided to an individual under all qualified plans, tax-sheltered annuities, and simplified employee plans (SEPs) maintained by any private or public employer or by certain related employers. Under a defined contribution plan (including an ESOP), present law provides an overall limit on annual additions with respect to each plan participant (sec. 415(c)). The annual additions generally are limited to the lesser of (1) 25 percent of an employee's compensation for the year, or (2) $30,000.

An employer's deductible ESOP contributions that are applied by the plan to the payment of interest on a loan to acquire employer securities, as well as any forfeitures of employer securities purchased with loan proceeds generally are not taken into account under the rules providing overall limits on contributions and benefits under qualified plans. However, such contributions and forfeitures are disregarded for purposes of the overall limits only if no more than 1/3 of the employer's contributions for the year is allocated to highly compensated employees. If this 1/3 requirement is satisfied, the $30,000 limit on contributions may be raised up to $60,000.

Possible Proposals

1. Repeal the special rules providing an exception to the prohibited transaction rules for ESOP loans. Repeal the special interest exclusion for a lender making a securities acquisition loan.
2. Repeal the special deduction limits for contributions to an ESOP.
3. Repeal the special limits on contributions on behalf of an employee to an ESOP.

Pros and Cons

Arguments for the proposals

1. Employers often prefer to used leveraged ESOPs as a corporate financing technique that, because of the special tax benefits available to the ESOP, the employer, and certain lenders, can produce a lower cost of borrowing than if conventional debt or equity financing were used. Thus, the employer corporation may often use the special tax benefits designed to encourage greater

capital ownership by employees to generate general working capital or for other purposes that do not primarily benefit employees. Such a use of the tax benefit is inappropriate.

2. Leveraged ESOPs are also used as a method of protecting a company against a hostile takeover. A sale of stock to an ESOP will not necessarily dilute control of the company to the same degree as a sale to outside parties. The stock purchased by a leveraged ESOP is not immediately credited to employees' individual accounts, but is held in a suspense account and released for allocation to employees' accounts as the acquisition loan is repaid. During this period, the shares may be voted by plan trustees (who are frequently representatives of the management of the company) subject to the fiduciary rules of ERISA. It is not appropriate for the tax benefits accorded to ESOPs to be used by corporate managers who want to protect themselves against the risk of takeover.

3. The existence of special contribution and deduction limits for contributions by an employer to an ESOP creates an incentive to maintain an ESOP as a primary source of retirement income for employees. The tax laws should not create an incentive for an employer to maintain one type of retirement plan to the exclusion of other types. If an employer experiences financial difficulty, employees with retirement savings concentrated primarily in employer stock may be subject to a double risk of loss. Not only would employees lose their jobs (and employer contributions to their retirement plan possibly would be reduced or eliminated), but they also may suffer from decreases in the value of the securities and the amount of dividends paid thereon. Moreover, if a plan is permitted to invest substantially in employer securities, a plan fiduciary could be subject to great pressure to time purchases and sales to improve the market in those securities, whether or not the interests of plan participants were adversely affected.

Arguments against the proposals

1. The tax incentives historically afforded ESOPs represent an attempt to balance tax policy goals encouraging employee stock ownership with those encouraging employer-provided retirement benefits. The special tax benefits for ESOPs are designed to encourage the use of a special corporate financing tool (leveraged ESOPs) to expand the ownership of capital in the U.S. Leveraged ESOPs have a legitimate function as corporate financing devices. The corporation is able to obtain low-cost financing for plant expansion and other purposes, enabling it to become more productive, with the corporation's employees, rather than outside investors, receiving the benefits.

2. Employers who incur debt through an ESOP in order to purchase a block of employer securities to be held by the ESOP cannot reasonably be expected to retire the debt on a nondeductible basis. However, absent special deduction limits, an employer could not make deductible payments of interest and principal to retire the debt in many cases.

3. Repeal of the special contribution and deduction limits for ESOPs would restrict investment in employer securities and, therefore, would deny retirees the opportunity to benefit from growth in the value of employer securities.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Repeal special ESOP rules	0.1	0.2	0.2	0.5

6. Accounting Provisions

a. Accrual accounting requirement for large nonfarm businesses

Present Law

In general, a nonfarm taxpayer must use an accrual method of accounting if the taxpayer's average annual gross receipts for any three-taxable year period preceding the year in question exceed $5 million. Individuals, partnerships (other than partnerships having a C corporation as a partner), S corporations, and "qualified personal service corporations" are exempt from the required use of an accrual method.

A qualified personal service corporation is a corporation meeting a function test and an ownership test. The function test is met if substantially all the activities of the corporation are the performance of services in the field of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. In general, the ownership test is met if substantially all of the value of the outstanding stock of the corporation is owned by present or retired employees.

Possible Proposal

Under the President's tax reform proposal, use of the cash method of accounting would have been denied to any taxpayer unless the taxpayer (1) had less than 5 million of gross receipts and (2) with respect to a trade or business other than farming, had not regularly used any other method of accounting for the purpose of reports or statements to shareholders, partners, other proprietors, beneficiaries, or for credit purposes. No exception was provided for individuals, partnerships, S corporations, or personal service corporations. (See section II. D. 7. a., below, for a discussion of accrual accounting proposals related to farming businesses.)

Pros and Cons

Arguments for the proposal

1. An accrual method of accounting more properly reflects the economic income of a taxpayer.

2. Although the simplicity of the cash method may justify its use by smaller, less sophisticated taxpayers, there is no sound policy reason to permit its use by larger businesses which have the capacity to deal with the additional burdens of accrual accounting.

3. By allowing large taxpayers operating in certain business forms or in certain fields to use the cash method, present law permits distortion of income and the deferral of taxes by these taxpayers; it thus provides a subsidy to this group, discriminating against

other similarly situated taxpayers, some of whom may be in direct competition with the exempted businesses.

Arguments against the proposal

1. Any benefits achieved by requiring these types of taxpayers to use the accrual method of accounting would be outweighed by the burdens of compliance.

2. The cash method of accounting is more consistent with the manner in which professional partnerships and corporations conduct their business and intra-partnership or intra-corporate affairs.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Cash accounting denied for large nonfarm businesses...........	0.1	0.3	0.3	0.8

b. LIFO method of inventory accounting

Present Law

Inventory methods

Under present law, if the production, purchase, or sale of merchandise is a material income-producing factor to a taxpayer, the taxpayer is required to use an accrual method of accounting and to maintain inventories. Acceptable methods of accounting for inventories include specific identification, first-in first-out ("FIFO"), last-in first-out ("LIFO"), and, in certain limited circumstances, average cost.

Under the LIFO method, the costs of the items most recently purchased or produced are matched against sales. When costs are rising, the LIFO method results in a higher measure of cost of goods sold and, consequently, a lower measure of taxable income. Thus, compared to the FIFO method, the LIFO method allows the recognition of taxable income to be deferred. Taxpayers are not required to pay interest on the resultant deferral of tax liability. The extent of the deferral can be measured by the LIFO reserve, which is the excess of the taxpayer's LIFO inventory over the inventory that the taxpayer would be allowed under the FIFO method.

The LIFO method is not permitted for purposes of measuring earnings and profits. In addition, recapture (i.e., inclusion in income) of the LIFO reserve is required in certain mergers and acquisitions.

Interest charge on certain installment sales

Present law (as amended by the 1986 Act) provides an election under which a dealer can avoid the application of the proportionate disallowance rule with respect to installment obligations that arise from certain sales of timeshares and residential lots. A dealer that makes this election with respect to an installment obligation is required to pay interest on any tax that is deferred as a result of payments on the obligation being received in any year following the year of sale. Interest is computed for the period from the date of the sale to the date the payment is received. The interest rate used for this purpose is 100 percent of the applicable Federal rate.

Interest charge on long-term contracts

A taxpayer using the percentage of completion method with respect to a long-term contract is required to determine upon completion of the contract the amount of tax that would have been paid in each taxable year if the income from the contract had been computed by using the actual gross contract price and total contract costs, rather than the anticipated contract price and costs. Interest must be paid by the taxpayer if, applying this "lookback" method, there is an underpayment by the taxpayer with respect to a taxable year. Similarly, under the "lookback" method, interest must be paid to the taxpayer by the Internal Revenue Service if there is an overpayment. The rate of interest for both underpayments and overpayments is the rate applicable to overpayments of tax (i.e., the short-term Federal rate plus two percentage points).

Possible Proposals

1. Repeal the LIFO method of inventory accounting. Require the LIFO reserve to be included in income ratably over a 10-year period.
2. Similar to the interest charge on installment sales of timeshares and residential lots and the interest charge on the long-term contracts, require the payment of interest on the tax savings that result from the continued use of the LIFO method. Calculate the interest due for any year by applying the underpayment rate to the additional tax that would result if the LIFO reserve is included in income during such year.

Pros and Cons

Arguments for the proposals

1. The use of the LIFO method results in an inappropriate deferral of tax especially during periods of high inflation. This deferral may extend for the life of the taxpayer.
2. The LIFO method is inordinately complex, and may result in difficult audit problems for the Internal Revenue Service. To the extent that the Internal Revenue Service is unable to enforce the LIFO rules, taxpayers may prolong or increase the deferral benefits.
3. The tax rate reduction in the 1986 Act provided a windfall to taxpayers that used the LIFO method to defer tax from pre-1986 years.

Arguments against the proposals

1. The LIFO method is considered by many as the most accurate measure of income during periods of inflation. The LIFO method is an acceptable method of accounting for financial statement purposes.
2. The LIFO method has been simplified in the 1986 Act for small businesses.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
(1) Repeal LIFO and amortize income change	2.6	4.6	4.7	11.9
(2) Charge interest on LIFO reserves	1.5	2.6	2.7	6.7

c. Accounting for long-term contracts

Present Law

Taxpayers engaged in the production of property under a long-term contract must compute income from the contract under either the percentage of completion method or the percentage of completion-capitalized cost method. An exception is provided for certain small businesses with respect to contracts to be completed within two years.

Under the percentage of completion method, the taxpayer must include in gross income for the taxable year an amount equal to the product of (1) the gross contract price and (2) the percentage of the contract completed during the taxable year. The percentage of a contract completed during the taxable year is determined by comparing costs incurred with respect to the contract during the year with the estimated total contract costs. In the taxable year in which the contract is completed, a determination is made whether the taxes paid with respect to the contract in each year of the contract were more or less than the amount that would have been paid if gross income had been computed by using the actual gross contract price and the actual total contract costs, rather than the anticipated contract price and costs. Interest must be paid by the taxpayer, if, applying this "lookback" method, there is an underpayment by the taxpayer with respect to a taxable year. Similarly, interest must be paid to the taxpayer by the Internal Revenue Service if there is an overpayment.

Under the percentage of completion-capitalized cost method, the taxpayer must take into account 40 percent of the items with respect to the contract under the percentage of completion method. The remaining 60 percent of the items under the contract must be taken into account under the taxpayer's normal method of accounting, for example, the completed contract method or an accrual method. Under the completed contract method, income from a contract is included and contract costs are deducted upon final completion and acceptance of the contract. All costs that directly benefit or are incurred by reason of a taxpayer's long-term contract activities must be allocated to its long-term contracts in the manner provided in Treasury the regulations under section 451 for extended period long-term contracts.

Possible Proposal

Require 100 percent of all long-term contracts (other than contracts of small businesses exempted under present law) to be reported on the percentage of completion method. This could be accomplished by immediate repeal of the completed contract method and other methods, or by phasing out the use of these methods over a period of years.

Pros and Cons

Arguments for the proposal

1. The percentage of completion method is the only method that properly reflects the economic income of a taxpayer with respect to long-term contracts. The completed contract method, the accrual shipment method, and other similar methods permit an unwarranted deferral of income from those contracts, and hence provide a subsidy to taxpayers allowed to use them.

2. Virtually all taxpayers reporting income on the completed contract method for tax purposes use the percentage of completion method for financial reporting purposes. A business should not be allowed to report little or no income for tax purposes while reporting large profits to its shareholders and creditors.

Arguments against the proposal

1. A taxpayer engaged in the performance of a long-term contract is generally not certain of the amount, if any, of the profit it will realize on the contract. It is therefore appropriate to determine the amount of profit (or loss) when the contract is completed and accepted.

2. A taxpayer has a right to the contract price only when the contract is completed or accepted. Thus, it "earns" any profit realized on a long-term contract only at that time, not on a proportionate basis over the term of the contract.

3. In the absence of substantial progress payments in excess of out-of-pocket expenses, taxpayers may not have sufficient funds to pay tax prior to completion of the contract.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
Completed contract method:				
(1) Require use of 100% percentage of completion method for all long-term contracts for contracts entered into after December 31, 1987.	0.4	1.4	2.2	4.0
(2) Phase-in 100% percentage of completion method for contracts entered into after December 31, 1986 (60% in 1987, 80% in 1988, 100% in 1989 and thereafter)	0.8	1.3	1.7	3.8

d. Repeal of vacation pay reserve

Present Law

Under present law, an accrual-method taxpayer generally is permitted a deduction in the taxable year in which all of the events have occurred that determine the fact of a liability and the amount thereof can be determined with reasonable accuracy. Nonetheless, in order to ensure the proper matching of income and deductions in the case of deferred benefits for employees (such as vacation pay earned in the current taxable year, but paid in a subsequent year), an employer generally is entitled to claim a deduction in the taxable year of the employer in which ends the taxable year of the employee in which the benefit is includible in gross income. Consequently, an employer generally is entitled to a deduction for vacation pay in the taxable year of the employee for which the pay (1) vests (if the vacation pay plan is funded by the employer) or (2) is paid and for amounts which vest or are paid within 2 1/2 months after the end of the employer's taxable year. Under a special rule, an employer can elect to deduct an amount representing a reasonable addition to a reserve account for vacation pay earned by employees before the close of the current year and paid by the close of that year or within 8-1/2 months thereafter.

Possible Proposal

The special rule that permits taxpayers a deduction for additions to a reserve for vacation pay could be repealed. Under this proposal, deductions for vacation pay would be allowed in any taxable year for amounts paid, or funded amounts which vest, during the year or within 2-1/2 months after the end of the year.

Pros and Cons

Arguments for the proposal

1. Allowance of a deduction prior to the time vacation pay is paid overstates the amount of the deduction because of the time value of money, thus, providing a tax subsidy for vacation pay relative to regular compensation.

2. The reserve for vacation pay is an exception to the general rule of not allowing reserves for Federal income tax purposes.

Argument against the proposal

Allowing a deduction for vacation pay permits a more proper matching of the cost of providing vacation pay to the income that gave rise to the obligation to pay vacation pay.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Repeal vacation pay reserve..........	0.1	0.1	(*)	0.2

* Gain of less than $50 million.

e. Limitations on deductibility of advertising costs

Present Law

A deduction is allowed for all ordinary and necessary business expenses paid or incurred during the taxable year in carrying on a trade or business. No deduction is allowed for capital expenditures, including the cost of acquiring an asset having a useful life that extends substantially beyond the taxable year. Selling expenses, including costs relating to advertising and promotion of a product, are treated as ordinary and necessary business expenses and hence are fully deductible in the year paid or incurred.

Possible Proposals

1. Require that all or a specified portion of advertising costs paid or incurred during a taxable year be amortized over some period of time, rather than deducted currently.
2. Deny any deduction for advertising for, or promotion of, alcohol and/or tobacco products.

Pros and Cons

Arguments for the proposal

1. The benefit of amounts paid for advertising extend beyond the year of the expenditure. Requiring some portion of advertising costs to be deferred to a later year thus results in a more proper matching of the expenses with the income generated by them.
2. Advertising expenditures do not lead to increase competitiveness; they merely shift consumer buying priorities. Thus, there is no justification for a tax subsidy for these expenditures.
3. Permitting a current deduction for advertising costs creates a preference for businesses that invest in advertising over businesses that invest in tangible assets or other types of intangible assets, the costs of which must be depreciated or amortized.
4. Since it is difficult to determine precisely what portion of advertising costs benefits a particular year, it is appropriate to provide an assumed allocation of the benefit of such costs by statute.
5. Limitations on advertising deductions will have very little effect on those corporations which had the biggest tax increases under the 1986 Act. Rather, they would affect those that received the highest benefits from rate reduction.
6. Because of the adverse health effects of alcohol and tobacco products, it is inappropriate to allow a deduction for advertising and promoting them.

Arguments against the proposal

1. Advertising costs are costs of selling a product in the current taxable year, and do not create a separate and distinct asset having

a life that extends substantially beyond the end of the year. Accordingly, they should be fully deductible in the year incurred.

2. Severe definitional and administrative problems will result in trying to differentiate between advertising and promotional expenses, on the one hand, and fully deductible selling expenses on the other hand.

3. Even if some portion of advertising costs theoretically benefits future taxable years, it is only a de minimis amount. In any event, it is impossible to verify the degree or proper allocation of the benefit to future years.

4. It is not appropriate tax policy to restrict the deductibility of advertising expenses while retaining expensing for similar expenditures such as research and development.

5. Advertising provides a valuable service by providing information about prices and product quality that helps consumers make more informed decisions.

6. It is inappropriate to use discriminatory tax provisions to deal with non-tax issues involving alcohol and tobacco.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Advertising costs:				
(1) Overall—				
(a) Require a 4-year amortization of 20% of advertising costs incurred during taxable years	3.0	4.5	3.3	10.8
(b) Deny deduction for 20% of corporate advertising costs and amortize remainder over 2 years for firms over $5 million of gross receipts	12.7	15.7	9.5	37.9
(2) Deny advertising deduction and promotion expense deduction for—				
(a) Tobacco products	0.5	0.8	0.9	2.2
(b) Alcohol products	0.3	0.5	0.6	1.4

f. Elimination of deferral of income of cooperatives

Present Law

Certain corporations are eligible to be treated as cooperatives and taxed under the special rules of subchapter T of the Code. In general, the subchapter T rules apply to any corporation operating on a cooperative basis (except mutual savings banks, insurance companies, most tax-exempt organizations, and certain utilities).

In general, a cooperative may adopt any fiscal year as a taxable year. For Federal income tax purposes, a cooperative generally computes its taxable income as if it were a taxable corporation, with one important exception—the cooperative may deduct from its taxable income patronage dividends paid. In general, patronage dividends are profits of the cooperative that are rebated to its patrons pursuant to a preexisting obligation of the cooperative to do so. In computing its taxable income for a taxable year, the cooperative may deduct patronage dividends that are paid up to eight and one-half months after the close of the taxable year.

Members of the cooperatives who receive patronage dividends must treat the dividends as income, reduction of basis, or some other treatment that is appropriately related to the type of transaction that gave rise to the dividend. For example, where the cooperative markets a product for one of its members, patronage dividends attributable to the marketing are treated as additional proceeds from the sale of the product and are includible in the recipiént patron's income. Recipients of the patronage dividends generally take such dividends into account when received, even if the amounts are deducted by the cooperative in a prior period.

Thus, under present law, income earned by a cooperative generally is intended to be subject to one level of tax which is to be borne by the patron of the cooperative. Nevertheless, income earned by a cooperative may not be taxed to a patron until a period following the period in which the income was earned. This deferral may occur, for example, if the cooperative has a fiscal year and pays out its income for the fiscal year to calendar year taxpayers, but the distribution is during the portion of the fiscal year following the close of the calendar year.

Such deferral also may occur where the cooperative has a calendar year as a taxable year, but receives deductions for patronage dividends paid after the close of the calendar year while such dividends are taken into account by calendar year patrons only when received. Moreover, the period of deferral may be extended, in some cases for several years, where a cooperative pays patronage dividends to patrons that are themselves cooperatives.

Various provisions of the Tax Reform Act of 1986 (the "1986 Act") restricted the ability of other pass-through entities such as partnerships and trusts to use taxable years other than the calendar year in order to prevent deferral of tax by partners and beneficiaries. Other provisions of the 1986 Act limited the deferral of income arising from the ability of regulated investment companies and real estate investment trusts to receive dividends paid deductions for dividends paid after the end of the calendar year.

Possible Proposal

In order to prevent the deferral of income earned through a cooperative:

1. all cooperatives could be required to adopt the calendar year as their taxable year; and
2. cooperatives could be permitted to deduct patronage dividends only in the year that the dividends are paid.

Pros and Cons

Arguments for the proposals

1. The proposal would require income that is earned by a cooperative to be recognized currently either by the cooperative or by its patrons. The "single tax" regime for cooperatives would be preserved, since the cooperative would still receive a deduction at the time that patronage dividends are paid.
2. The proposal would reduce the advantage of cooperatives that compete with investor owned business enterprises.
3. The proposal is an extension of the provisions of the 1986 Act that attempted to limit the deferral of income through other pass-through entities.

Arguments against the proposals

1. Under the proposal, cooperatives would be required to distribute all of their taxable income for a taxable year in order to avoid paying tax for that taxable year. To the extent that cooperatives distribute sufficient amounts to avoid paying tax, or to the extent that cooperatives actually pay tax, the amount of the cooperative's capital is diminished and would need to be replaced from other sources. This may be undesirable where the cooperative is not of a type that competes with investor owned business enterprises but rather is, for example, an entity used by small farmers to allow them to compete more effectively.
2. The calendar year may not be a "natural business year" for certain cooperatives, and use of the calendar year may be inconvenient for such cooperatives.

g. Current accrual of market discount on bonds

Present Law

In general, present law requires inclusion of market discount on bonds only upon redemption or other disposition of the bond. Thus, a taxpayer who purchases a bond after original issue at a price less than its face amount (or adjusted issue price in the case of a bond originally issued at a discount) does not, absent an election, include in income any portion of the discount prior to disposition of the bond. Except in the case of tax-exempt obligations, market discount that accrues while the taxpayer holds such a bond is treated as ordinary income upon the disposition of the bond up to the amount of gain realized. Interest on indebtedness incurred or continued to purchase or carry a bond with market discount is deferred to the extent that such interest does not exceed the market discount accruing on the bond. Any interest expense so deferred is allowed when the market discount is recognized.

Possible Proposals

1. Require market discount on all bonds to be included currently as interest income by the holder as such discount accrues on an economic basis. Holders of discount bonds would know the amount of economic accrual of market discount by requiring brokerage firms (or other intermediaries) to provide relevant information to purchasers of market discount bonds. As an alternative to economic accrual, the holder could be permitted to use a simplified method (*e.g.*, straight line, proportional) for computing market discount allocable to a period.

2. Require current accrual only for market discount on bonds held by a defined class of "sophisticated" taxpayers, *e.g.*, those that must accrue market discount on short-term obligations (*i.e.*, banks, regulated investment companies, taxpayers using an accrual method of accounting and taxpayers holding obligations primarily for sale to customers in the ordinary course of the taxpayer's trade or business).

Pros and Cons

Arguments for the proposal

1. From the holder's point of view, market discount is the economic equivalent of interest and is indistinguishable from original issue discount, which a holder must include in income on an annual basis.

2. Requiring current inclusion of market discount would help correct certain asymmetries in present law. For example, present law already permits acquisition premium to be deducted on a current basis.

3. The proposal would eliminate the ability of taxpayers to offset, in effect, a capital loss against ordinary income, contrary to the general rules limiting the deductibility of capital losses. Where a bond that was purchased with market discount is later sold for an amount that is less than the taxpayer's original basis in the bond plus the amount of market discount that has accrued economically from the date of the acquisition, a portion of the accrued market discount (which is ordinary income) is offset by the capital loss resulting from decline in value of the bond. Under the proposal, the accrued market discount would be taken into account as ordinary income (with a corresponding increase in the taxpayer's basis in the bond) and any loss would be deductible as a capital loss.

4. The proposals would eliminate the need for the complex rules requiring deferral of interest on debt attributable to market discount bonds.

Arguments against the proposals

1. Requiring current inclusion of market discount in income would interfere with the efficient operation of the capital markets.

2. Holders of market discount bonds would be required to pay tax on income before cash is actually received, creating liquidity problems.

3. Unless the proposal is limited to sophisticated taxpayers or broad reporting requirements are imposed on brokerage houses to provide the holder (and the Internal Revenue Service) with the amount of discount that must be included in income, the proposals may be difficult to administer for both the holder, since the computation of the amount of accrued income on an economic basis is complex, and the Internal Revenue Service, since the Service does not presently receive information relating to the purchase of bonds in the secondary market.

h. Installment sales

Present Law

Under present law, a taxpayer who sells property ordinarily must recognize gain or loss at the time of the sale. However, a taxpayer who is eligible to use the installment method may defer the payment of tax and recognize gain from a sale of property in proportion to the payments received.

In general, the installment method may be used to report gain from the sale of personal property on the installment plan by dealers in personal property who regularly sell on the installment plan, or for other sales of property where at least one payment is to be made after the end of the taxable year in which the sale is made.

Use of the installment method is generally limited under the so-called "proportionate disallowance rule" for dealer sales of real property and dealer sales of personal property eligible to be reported on the installment method, as well as for sales of real property used in the taxpayer's trade or business or held for the production of rental income where the selling price of such real property is greater than $150,000. Under the proportionate disallowance rule, a pro rata portion of the taxpayer's indebtedness is allocated to, and is treated as a payment on, the installment obligations of the taxpayer.

Use of the installment method is not allowed for sales pursuant to a revolving credit plan and for sales of publicly traded property. In addition, the installment method may not be used for purposes of the alternative minimum tax for sales that are subject to the proportionate disallowance rule.

At the election of the seller, installment obligations arising from certain sales of residential lots and "timeshares" are not subject to the proportionate disallowance rule. Rather, such taxpayers may compute their tax liability under the installment method and are required to pay interest on the amount of deferred tax attributable to the use of the installment method.

Possible Proposals

1. Use of the installment method would be repealed for all sales by dealers and for all non-dealer sales that are subject to the proportionate disallowance rule.

2. Same as proposal 1, except that, for non-dealer sales, payment of the tax due on account of the sale may be deferred for an appropriate period with an appropriate interest charge.

Pros and Cons

Arguments for the proposals

1. Repeal of the installment method would result in income being measured more accurately by both dealers and non-dealers, and would result in application of the same rules for regular tax purposes as are applied for alternative minimum tax purposes.
2. Repeal of the installment method would eliminate the need to apply the complicated provisions of the proportionate disallowance rule.
3. Liquidity problems are more likely to occur in the case of non-dealer sales than in the case of dealer sales. Hence, an exception under which tax may be deferred with interest should be made for such sales.

Arguments against the proposals

1. Both dealers and non-dealers suffer the same liquidity problems that the use of the installment method is intended to alleviate.
2. The proportionate disallowance rule is an appropriate limitation on the use of the installment method because it generally reflects the extent to which the seller has received cash.

i. Amortization of intangibles

Present Law

Taxpayers may take depreciation or amortization deductions for the exhaustion, wear, tear, and obsolescence of property (sec. 167(a)). No such deductions are allowed, however, with respect to property that is not a wasting asset or property whose useful life cannot be estimated with reasonable accuracy. Deductions are generally allowed for the costs attributed to such intangible assets as patents or other statutory or contract rights that exist for a specific, non-extendible period of time. However, because goodwill does not have a determinable useful life, no depreciation deduction is allowed with respect to that intangible asset. Accordingly, the portion of the purchase price of a business that is allocated to goodwill may not be amortized or depreciated. Goodwill has been defined as the expectancy of continued patronage, for whatever reason, or as "the probability that old customers will resort to the old place".

Taxpayers frequently take the position that a substantial portion of the purchase price of a business is allocable to certain intangible assets other than goodwill, for which they attempt to establish a limited useful life and claim depreciation. The value of such other assets is often described as the value obtained from the existing customer base and the useful life is often said to be the time period over which that base may erode as customers move away or withdraw their level of patronage. Such assets include, for example, customer and subscription lists; patient or other client records; the existing "core" deposits of banks; insurance in force in the case of an insurance company; advertising relationships and customer or circulation base in the case of a broadcast or newspaper business; and existing market share in the case of any business.

In many instance, courts have refused to permit the amortization of such assets. The IRS has successfully argued that these items may be viewed as "mass assets" in that particular customers may be lost but others may be expected to replace them. Deductions have also been denied in many cases for such intangible assets as customer or client information that facilitates the business of serving customers. Such records have been described as simply an integral part of the goodwill of the business.

In some other cases, however, courts have permitted deductions for such items as customer lists or client information, stating that such assets are of use primarily as a resource for serving customers of the business but are not the same as goodwill. Still other cases have denied the deductions claimed in the particular case, but have suggested that if the taxpayers had presented better statistical evidence of the period over which the existing customer base declined, amortization might be permitted. The cases permitting or suggesting the possibility of a deduction have not always indicated whether it is necessary to take into account any expectation or evidence that new customers will replace those that die, move away, or otherwise sever their customer relationships.

Generally, costs attributable to the creation or acquisition of an asset that has a useful life of more than a year may not be currently deducted, but must be capitalized. Goodwill typically would have a life extending beyond one year and costs that can be related to its creation, such as those of certain extraordinary advertising campaigns, are required to be capitalized. However, it is possible that many taxpayers deduct currently costs that may contribute to the creation of goodwill, such as ordinary advertising or other ongoing business expenses. This may occur in part because of the difficulties of separately identifying which ordinary and necessary business expenses have created goodwill, and of determining when or whether "new" goodwill has been created.

Possible Proposals

1. Deny amortization or depreciation deductions for intangible assets representing the value of the existing customer base or market share.
2. Permit amortization of such intangible assets if a deduction might arguably be claimed under present law, but permit the deduction only over a uniform, prescribed period of substantial duration (e.g., 40 years).

Pros and Cons

Arguments for the proposals

1. Assets similar to goodwill, such as intangible assets reflecting the value of a customer base or market share should not be amortized more rapidly than goodwill.
2. The key factors that make goodwill a nondepreciable asset are also present in the case of other intangible assets representing the value of the customer base or market share. One is the difficulty of determining a useful life. Although it is possible that goodwill may diminish over time if it is not continually renewed, it is extremely difficult to determine the extent to which "old" goodwill is retained or "new" goodwill is created, through ongoing business operations. This difficulty exists as well for other assets related to the value of the customer base or market share. Likewise, taxpayers that seek to amortize the costs of acquiring such intangibles, on the grounds that they are "wasting" assets with a determinable useful life extending beyond a year, may be capitalizing little if any of their ongoing business expenses as costs of creating the new "customer" base or market share that replaces the one that they have written off.

Arguments against the proposals

1. Present law with respect to goodwill may be unduly restrictive because goodwill may erode over time if it is not continually renewed. Taxpayers should thus be permitted to accomplish a result similar to a deduction for goodwill by attempting to establish a de-

terminable useful life for such significant portion of the intangible asset value related to customer base or market share.

2. Taxpayers should not be precluded from attempting to establish a limited useful life for any asset.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
Amortization of intangibles...........	([1])	([1])	([1])	0.1

[1] Gain of less than $50 million.

j. Disallow interest deductions allocable to tax-exempt installment sales of property to State or local governments

Present Law

Installment sales to State and local governments

Under present law, if a taxpayer sells property to a State or local government in exchange for an installment obligation, interest on the obligation may be exempt from tax.

If an installment obligation is received in exchange for certain types of property (including most dealer property and certain real property held for use in a trade or business or for the production of rental income), then use of the installment method by the seller is limited under a formula that allocates a portion of the taxpayer's indebtedness among the taxpayer's installment obligations.

Disallowance of interest deductions

Present law provides that no deduction is allowed for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is not subject to tax.

Under present law, in the case of a corporation other than a financial institution or a dealer in tax-exempt obligations, interest on the corporation's indebtedness generally is not disallowed where during a taxable year the average amount of the corporation's tax-exempt obligations does not exceed 2 percent of the average total assets held in the active conduct of a trade or business. In many cases, such taxpayers may hold tax-exempt obligations that exceed 2 percent of their assets, yet take the position that none of their interest expense is disallowed.

For example, such taxpayers may rely on an Internal Revenue Service ruling (Revenue Procedure 72-18) under which interest on such a corporation's indebtedness is not disallowed where the corporation acquires nonnegotiable tax-exempt obligations in the ordinary course of business for services performed for, or goods supplied to, State or local governments. Although the IRS has issued a private letter ruling indicating that a tax-exempt obligation would be treated as nonnegotiable for these purposes only if the obligation cannot be sold, many taxpayers take the position that nonnegotiable obligations are those obligations that are so treated under the Uniform Commercial Code (U.C.C.).

Present law provides that, in the case of a financial institution, no deduction is allowed for the portion of interest expense that is allocable to tax-exempt interest. In general, the allocation of the interest expense of the financial institution for this purpose is based on the ratio of the average adjusted bases of the tax-exempt obligations acquired after August 7, 1986, to the average adjusted bases of all assets of the taxpayer.

Possible Proposals

1. Where a taxpayer sells property to a State or local government and receives an obligation of such government the interest on which is exempt from tax, a portion of the taxpayer's interest deductions could be denied based on an allocation of the taxpayer's indebtedness to such obligation. The denial could or could not be dependent upon whether the taxpayer accounts for its income with respect to the sale on the installment method.

The allocation of the taxpayer's debt to the obligations received from the State or local government could be based on either a pro rata allocation among the taxpayer's assets determined on a yearly basis, or based on the somewhat different allocation formula employed for purposes of limiting the use of the installment method.

2. The IRS position, that a tax-exempt obligation must be nonsaleable in order to be treated as nonnegotiable, could be codified. In addition, the 2-percent *de minimis* rule could be repealed.

Pros and Cons

Arguments for the proposals

1. In general, permitting the holding of tax-exempt obligations without limiting the deductibility of interest expense may be viewed as a tax subsidy. This tax subsidy may create a competitive advantage for large manufacturers who sell equipment to State and local government over taxpayers who are either smaller in size or who only provide financing for State and local governments to purchase equipment (and are therefore less likely to benefit from the 2 percent *de minimis* exception).

2. Pro rata allocation of indebtedness among assets (either in the manner prescribed for financial institutions or for purposes of the installment sale rules) avoids the difficult and often subjective inquiry relating to when indebtedness is incurred or continued to purchase or carry tax-exempt obligations. If the taxpayer uses the installment method to account for gain from the sale to the State or local government, the taxpayer already may be required to allocate indebtedness to the installment obligation in the manner prescribed by the installment sale rules.

3. The original exception for nonnegotiable instruments was intended for a narrower class of obligations than those that are nonnegotiable under the U.C.C. (which was not in effect at the time that the exception was carved out).

Arguments against the proposals

1. To the extent that the benefit of any tax subsidy is passed along to the State or local government, the proposal may have the effect of raising the financing costs for a State or local government in the same manner as partially or fully taxing the interest on the government's obligation.

2. The proposal to allocate debt among tax-exempt obligations received in exchange for property sold by the taxpayer may have the

effect of denying interest deductions on indebtedness if a taxpayer sells property to a State or local government, where the deductions would not be denied if the taxpayer simply purchased for cash an obligation of the State or local government the interest on which was exempt from tax.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
Apply section 265 to installment sales to State and local governments	[1]	0.1	0.1	0.2

[1] Gain of less than $50 million.

k. Below-market loans to certain continuing care facilities

Present Law

Under present law, certain loans that bear interest at below-market rates are treated as loans that bear interest at a market rate accompanied by a payment from the lender to the borrower that is characterized in accordance with the substance of the particular transaction (e.g., gift, compensation, dividend, etc.). The market rate used for this purpose is determined by reference to market yields on Treasury obligations of similar maturity.

The rules relating to below-market loans apply to (1) loans where the foregone interest is in the nature of a gift, (2) loans to an employee from an employer or to an independent contractor from one for whom the independent contractor provides services, (3) loans between a corporation and a shareholder of the corporation, (4) loans of which one of the principal purposes is the avoidance of any Federal tax, and (5) to the extent provided in Treasury regulations, any below-market loan if the interest arrangement of such loan has a significant effect on any Federal tax liability of either the lender or the borrower.

An exception from the below-market loan rules is provided for certain loans to certain "continuing care facilities." In exchange for the making of such below-market loans, individual lenders may receive housing, meals and other personal consumption items in addition to a promise of long-term nursing care if necessary.

Possible Proposal

Provide that below-market loan rules apply to below-market loans to continuing care facilities and other similar facilities that provide consumption items in connection with the making of a below-market loan.

Pros and Cons

Arguments for the proposal

1. Below-market loans to continuing care or like facilities may have the effect of allowing individuals to avoid tax on income that is used to pay for certain items.

2. Continuing care or like facilities that raise capital in the form of below-market loans have a competitive advantage compared to comparable facilities that raise capital by more traditional means.

Argument against the proposal

Continuing care facilities and other similar facilities provide a valuable service to elderly persons who wish to provide for present or possible future long-term care needs, and should be encouraged by permitting the use of below-market loans.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Below-market loans to certain continuing care facilities............	([1])	([1])	([1])	([1])

[1] Gain of less than $50 million.

7. Farming Provisions

a. Accrual accounting requirement for large farming businesses

Present Law

In general, taxpayers required to maintain inventories for a particular trade or business must use an accrual method of accounting for that trade or business. A taxpayer is required to maintain inventories for a trade or business if the production, purchase, or sale of goods is an income-producing factor.

Special rules apply in the case of taxpayers engaged in the trade or business of farming. Such taxpayers generally may use the cash receipts and disbursements method of accounting for the business even though it involves the production and sale of goods. However, if the taxpayer is a corporation (other than an S corporation or a family-owned C corporation) or is a partnership with a corporate partner and has gross receipts of more than $1 million for any taxable year beginning after 1975, an accrual method must be used. In general, a family-owned corporation is one 50 percent or more of whose stock is owned by members of the same family. Certain closely held corporations substantially owned by two or three families on October 4, 1976, and at all times thereafter also qualify as family-owned for purposes of this exception.

Separate rules require use of an accrual method of accounting by any C corporation or partnership having a C corporation as a partner—without regard to whether the taxpayer is required to maintain inventories—if the taxpayer's average annual gross receipts for the three-taxable year period ending with the year exceed $5 million. These rules do not apply, however, if the taxpayer is engaged in the trade or business of farming or raising timber or ornamental trees that are more than six years old at the time severed from the roots. Use of an accrual method is required without regard to gross receipts, and notwithstanding the fact that it is engaged in farming, if the taxpayer is a tax shelter.

Possible Proposals

1. Under the President's tax reform proposal, use of the cash method of accounting would have been denied to a farming business unless the taxpayer has less than $5 million of gross receipts test. (This rule would have applied in addition to the rules requiring use of an accrual method by farming corporations or partnerships having a corporate partner.)

2. Use of the cash method of accounting could be denied to taxpayer's annual gross receipts exceed $50 or $100 million.

Pros and Cons

Arguments for the proposals

1. Allowing taxpayers engaged in farming to use the cash method of accounting distorts their income and permits a deferral of taxes. Although the simplicity of the cash method may justify its use by smaller, less sophisticated taxpayers, there is no sound policy reason to permit its use by larger farming businesses which have the capacity to deal with the additional burdens of accrual accounting.

2. Allowing use of the cash method by large farming businesses that happen to be family-owned acts as a subsidy to these businesses and gives them an advantage over other corporations of the same size that are in direct competition with them.

Argument against the proposals

The subsidy provided to farming businesses by allowing them to use the cash method serves social and economic objectives. Specifically, it helps to insulate these businesses and, in some cases, smaller farms working for them under contract, from fluctuations in the world market for farm products.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal [1]	1988	1989	1990	1988–90
Cash accounting:				
Repeal for farms with gross receipts over—				
(1) $100 million	0.1	0.1	0.1	0.3
(2) $50 million	0.1	0.2	0.2	0.5
(3) $5 million (President's tax reform proposal)	0.2	0.3	0.3	0.8

[1] All proposals would be effective for taxable years beginning after December 31, 1987.

b. Treat farm losses like real estate losses under the passive loss rules

Present Law

Present law, as amended by the 1986 Act, provides that deductions from passive trade or business activities, to the extent they exceed income from all such passive activities (exclusive of portfolio income), generally may not be deducted against other income. Suspended losses are carried forward and treated as deductions from passive activities in the next year. Suspended losses are allowed in full when the taxpayer disposes of his entire interest in the activity to an unrelated party in a transaction in which all realized gain or loss is recognized. The provision applies to individuals, estates, trusts, and personal service corporations. A special rule limits the use of passive activity losses and credits against portfolio income in the case of closely held corporations.

An activity generally is treated as passive if the taxpayer does not materially participate in it, i.e. the taxpayer is not involved in the operations of the activity on a basis which is regular, continuous, and substantial. Retired farmers and surviving spouses of farmers generally are treated as continuing to materially participate after retirement or death, as the case may be.

Rental activities are defined as passive activities, without regard to material participation. A special rule provides that up to $25,000 of losses and (deduction equivalent) credits from a rental real estate activity (generally, one in which the taxpayer actively participates) are allowed against other income for the year. The $25,000 amount is phased out between $100,000 and $150,000 of adjusted gross income.

Possible Proposal

Losses from farming activities could be treated in the same manner as losses from rental activities. Thus, farm losses would be treated as losses from passive activities for purposes of the passive loss rule and could not offset income from other activities prior to the time the farming activity is disposed of. An exception similar to the allowance of up to $25,000 of losses from certain rental real estate activities could allow individuals who materially participate (within the meaning of the passive loss rule) in the farming activity to offset up to $25,000 of non-farm income, with a phase-out of the $25,000 amount between $100,000 and $150,000 adjusted gross income.

Pros and Cons

Arguments for the proposal

1. Until a taxpayer disposes of his or her interest in a farming activity, the losses may not represent economic losses (because of the use of the cash method of accounting or other tax preferences) and should not be allowed to offset other income.

2. High-income taxpayers often offset non-farm business income with farming losses and thereby avoid paying substantial income tax.

3. The ability of high income individuals to use immediately farm tax losses to offset other income may give time an unfair advantage in competing with real farmers and distort the farm economy. The allowance of up to $25,000 of losses against nonfarm income will be sufficient for the person whose main livelihood is farming.

Arguments against the proposal

1. Farming is a risky business in which many individuals lose money and those losses should be allowed to offset other income prior to disposing of the farm.

2. Unlike rental activities, farming is a labor-intensive business in which services of the taxpayer are likely to be a material income producing factor. Thus, the rationale for treating rental activities generally as passive should not apply to farming.

3. Farming operations should not be discouraged by tax law limitations.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Treat farm losses like real estate losses under the passive loss rules	0.4	1.2	1.4	3.0

c. Increase cost recovery period for single-purpose agricultural structures

Present Law

For purposes of ACRS and the alternative depreciation system, single-purpose agricultural and horticultural structures (described in ADR class 01.3) are assigned an ADR midpoint life of 15 years. As a result of assigning a 15-year midpoint, the cost of this property is recovered over seven years under ACRS.

Possible Proposal

Under ACRS, the cost of single-purpose agricultural and horticultural structures (except greenhouses and mushroom houses) could be recovered over 15 years.

Argument for the proposal

Under the ADR system, farm buildings were assigned an ADR midpoint of 25 years. Under the general rules, the cost of property with an ADR midpoint of 25 years is recovered over 20 years. Providing a special, accelerated recovery period for such structures encourages tax-shelter motivated investment in the farming sector. Such investment hinders, rather than assists, family farming activities.

Argument against the proposal

The high-risk nature of many of the farming activities (e.g., chicken farming) in which single-purpose agricultural structures are used necessitates continuation of preferential subsidies.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
Increase cost recovery period for single-purpose agriculture structures to 15 years	[1]	[1]	[1]	[1]

[1] Gain of less than $50 million.

8. Financial Institutions

a. Repeal tax-exempt status of credit unions

Present Law

Credit unions are exempt from Federal income tax under present law. This exemption applies regardless of whether, or to what extent, income of the credit union is distributed as dividends. Both State and Federally chartered credit unions are exempt from tax.

Possible Proposal

Under the President's 1985 tax reform proposal, the tax exemption would have been repealed for credit unions having assets of $5 million or more.

Credit unions could be taxed in a manner similar to thrift institutions (e.g., savings and loans and mutual savings banks). Retained earnings of a taxable credit union (i.e., earnings not distributed as dividends to members) would be subject to tax at the credit union level, while dividends would (as under present law) be taxable upon receipt by individual members. Alternatively, a specified amount of credit union income could be exempt from tax.

Pros and Cons

Arguments for the proposal

1. Credit unions, especially larger credit unions, offer services similar to those provided by other financial institutions. Allowing them to be tax-exempt provides an unfair competitive advantage.

2. The Tax Reform Act of 1986 significantly reduced the tax advantages enjoyed by other financial institutions, thereby making credit unions have an even larger competitive advantage.

Arguments against the proposal

1. Credit unions are distinguished from other financial institutions, because they are more directly controlled by their members, and generally are limited to making consumer loans.

2. Tax exemption enables credit unions to act in the interest of their members, rather than seeking higher returns in other, possibly riskier ventures.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
Repeal tax-exempt status of credit unions	0.2	0.4	0.4	1.0

b. Tax treatment of recoveries of bad debts of thrift institutions

Present Law

Present law provides that no gain or loss (including any bad debt) is recognized by a thrift institution where it forecloses on property or acquires property that was security for a loan. Any gain or loss on the disposition of such property is treated as having the same character as that of the loan. Finally, present law provides that "any amount realized . . . with respect to such property shall be treated . . . as a payment on account of such indebtedness. . . ."

In *Gibralter Financial Corporation of California* v. *United States*, 86-1 U.S.T.C. par. 9405 (Ct.Cl. May 9, 1986), the Court of Claims held that the full amount realized on the sale of property acquired by a thrift institution by foreclosure reduces the amount of the reserve for bad debts rather than reducing the reserve by the amount of the loan and recognizing income on the excess of the amount realized over the amount of the loan.

Thrift institutions may compute the addition to the reserve for bad debts under one of two methods. Under the experience method, an addition to the reserve for bad debts is permitted to increase the balance of the reserve at the end of the taxable year to a set dollar amount. Thus, amounts added to the reserve from dispositions of property acquired by foreclosure would reduce the amount of deduction permitted for additions to the reserve under the experience method. Under the percentage of taxable income method, the addition to the reserve for bad debts is 8 percent of the taxable income of the thrift institution. Since the addition to the reserve for bad debts under this method generally is computed by reference to the taxable income of the thrift institution, the size of the reserve does not affect the amount of the bad debt deduction for additions to the reserve.

Possible Proposal

Amounts realized on the disposition of property acquired by a thrift institution by foreclosure or which secured a loan owed to the thrift institution would be added to the reserve for bad debts only to the extent of the basis of the thrift institution in the loan. Amounts realized in excess of the basis of the loan would be treated as ordinary income.

Pros and Cons

Argument for the proposal

By allowing amounts to be charged to the reserve for bad debts in excess of the amount of the loan, the court in the *Gibralter Fi-*

nancial Corporation case effectively would exempt gain on the sale of foreclosed property from taxation for thrift institutions using the percentage of taxable income method for computing the addition to the reserve for bad debts.

For example, where a thrift institution made a mortgage loan of $100 to finance the purchase of a residence, later acquired the mortgaged property in a foreclosure sale, and subsequently sold the property for $125, the thrift institution realized a gain of $25. Nonetheless, that gain would not be taxed because, under the *Gilbralter Financial Corporation* case, the full amount of the $125 sales proceeds would be added to the reserve for bad debts and the dollar amount of the reserve does not affect the bad debt deduction of the thrift institution if it used the percentage of taxable income method.

Argument against the proposal

Adoption of the proposal would increase the income taxes of thrift institutions which are currently in a state of financial hardship.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
Tax treatment of recoveries of bad debt of thrift institutions....	([1])	([1])	0.1	0.1

[1] Gain of less than $50 million.

9. Corporate Provisions

a. Intercorporate dividends received deduction

Present Law

Under present law, corporations are entitled to a deduction equal to 80 percent of the dividends received from a domestic corporation. This results in a maximum effective tax rate (after 1987) of 6.8 percent on such intercorporate dividends. Dividends received from a subsidiary in which the distributee owns an 80-percent or more interest or from a small business investment company are fully deductible by the distributee. Dividends received from a corporation with which the distributee files a consolidated return are "eliminated" (that is, disregarded) in computing consolidated taxable income.

Special anti-abuse rules deny or reduce the benefit of the dividends received deduction in certain circumstances. The deduction is not available with respect to dividends received on stock that is not held with a substantial risk of loss for a specified period, generally more than 45 days (90 days in the case of certain distributions of preferred stock). The deduction is also denied to the extent the dividends are attributable to debt-financed portfolio stock. Portfolio stock for this purpose is stock representing less than 50 percent of the voting power and value of all stock in the corporation, but excluding certain stock in corporate joint ventures.

Finally, a corporate shareholder's basis in stock is reduced by the portion of a dividend eligible for the dividends received deduction if the dividend is "extraordinary." In general, a dividend is extraordinary if the amount of the dividend equals or exceeds 10 percent (5 percent in the case of preferred stock) of the shareholder's adjusted basis in the stock and the shareholder has not held the stock, subject to a risk of loss, for at least 2 years prior to the earlier of the date the dividend is declared, announced, or agreed to.

Possible Proposals

1. The deduction for intercorporate dividends could be eliminated for distributions with respect to newly issued (alternatively, newly acquired) stock that does not rise to the level of a direct investment in the underlying business. For example, the deduction might be denied unless the distributee's stock ownership exceeds some specified percentage (e.g., 10 or 20 percent) of the value and voting power of the distributing corporation.

2. The 80-percent dividends received deduction might be reduced to 75 percent, or some other percentage, of the amount of the dividend, or phased out entirely.

Pros and Cons

Arguments for the proposals

1. The most appropriate rationale for the dividends received deduction is that the distributing corporation is the corporate alter ego of the distributee corporate shareholder; i.e., the distributing corporation's earnings are indirectly those of the shareholder. This is a valid assumption only where the shareholder's interest in the distributing corporation is substantial. In the absence of such a substantial interest, dividends received by one corporation from another are indistinguishable from interest income or any type of income from an unrelated corporation. Furthermore, it is anomalous not to tax such dividends while gain recognized on a sale of stock (which may simply reflect undistributed earnings) is taxable.

2. Allowing the deduction for dividends on portfolio stock may cause distortions in the stock market and create a windfall for the corporate shareholder. Although the price that is paid by a corporate investor when it purchases stock is fixed by a market that includes fully taxable individual purchasers, a corporate shareholder receives a return on stock that is not fully taxable to it, but rather is taxed at a maximum rate of 6.8 percent.

3. The dividends received deduction may confer an unintended benefit in many cases. While it was intended to assure that earnings generally are taxed only once at the corporate level, the deduction is available whether or not the distributed earnings were taxed to the distributing corporation. Thus, the deduction may result in no corporate-level tax being paid. Allowance of the dividends received deduction for porfolio stock thus in effect permits tax benefit transfers among corporations. An issuing corporation that has net operating losses (and hence is unable to use additional interest deductions) may issue preferred stock to corporate shareholders in lieu of debt with a taxable yield. The preferred stock will sell at a higher price because of its low-tax return. In many cases such stock can be structured to have the economic and legal characteristics of debt.

4. The dividends received deduction creates incentives for corporations to engage in tax arbitrage transactions, necessitating complex anti-abuse provisions in the Code. These provisions are only partially successful in preventing such transactions.

Arguments against the proposals

1. The dividends received deduction is desirable to avoid (or minimize) multiple taxation of earnings at the corporate level. The rationale of the deduction, that corporate earnings should be taxed only once at the corporate level, is applicable irrespective of whether the corporate shareholder has a minimal or a substantial interest in the distributing corporation.

2. It is appropriate to provide a dividends received deduction without regard to whether the earnings were taxed to the distributing corporation. This permits the benefit of tax incentives such as accelerated depreciation to be enjoyed so long as earnings remain in corporate solution. This rationale should apply without regard to whether the earnings are distributed outside the group of corporate shareholders that has a direct investment in the activity.

3. Any windfall to corporate shareholders from a tax-free return may be diminished to the extent the market price of the stock is set by a market that includes tax-exempt investors.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Intercorporate dividends received deduction changed from 80 percent to 75 percent	0.1	0.2	0.3	0.6

b. Modify computation of earnings and profits for intercorporate dividends and basis adjustments (*Woods Investment Company*)

Present Law

In 1966, the Treasury Department issued consolidated return regulations adjusting a parent corporation's basis in the stock of a subsidiary by the earnings and profits of the subsidiary.

At the time these regulations were issued, virtually all "deferral" items that reduced taxable income also reduced earnings and profits and, correspondingly, reduced the basis of the parent corporation in the stock of a subsidiary under the regulations. For example, if a subsidiary generated accelerated depreciation deductions, that reduced the basis of its assets, such amounts reduced earnings and profits. Under the regulations the parent corporation's basis in the stock of the subsidiary is adjusted upward for accumulated earnings and profits and downward for deficits in earnings and profits. This basis thus reflected the fact that the group had received a reduction in tax by reason of the accelerated depreciation and the parent corporation's basis in the subsidiary stock thus tended to be adjusted in accordance with the basis of assets in the hands of the subsidiary. When the subsidiary was sold, there would be a corresponding increase in the amount of tax from the sale.

In later years, Congress amended the provisions of the Code that define earnings and profits to change the treatment of certain deferral items so that these did not reduce earnings and profits. The principal purpose of these changes was to prevent corporations with economic profits from making tax-free distributions to individual shareholders. This could occur if earnings and profits were reduced, because a distribution is a "dividend", taxable in full to an individual shareholder as ordinary income, only if it is paid out of earnings and profits. If it is not, the shareholder recovers basis first and thereafter may have capital gain income. Congress first changed the earnings and profits treatment of accelerated depreciation so that the full accelerated depreciation deduction did not reduce earnings and profits. In later years (1984), Congress made similar adjustments to earnings and profits for certain other deferral items, such as income reported on the installment sale basis or under the completed contract method of accounting. Under the 1984 changes, such items increased earnings and profits even though they had not yet been included in taxable income.

Although the changes to the definition of earnings and profits were intended to prevent tax-free distributions to individual shareholders, they also applied to corporate shareholders. A corporate shareholder is eligible for the dividends received deduction and thus, unlike an individual, may obtain a greater tax-free return if a distribution is a dividend than if it is not. A similar benefit may exist if the corporations are filing consolidated returns, since intergroup dividends are eliminated from income under the consolidated return regulations. Furthermore, even if there is not distribution in the consolidated return case, the increased earnings and profits prevents the parent's basis in the subsidiary's stock from reflecting the subsidiary's assets basis and the tax benefit that has reduced that basis.

In connection with the more recent of the changes to the definition of earnings and profits (in 1984), Congress recognized this potential and provided in the nonconsolidation case that the new rules (which prevented a reduction in earnings and profits for specified deferral items) do not apply for purposes of determining the income of a corporate distributee (or its basis in the distributing corporation's stock) if the corporate distributee owns 20 percent or more of the distributing corporation's stock. The legislative history to the 1984 changes indicated an expectation that consistent rules would be adopted in the consolidated return area, but the consolidated return regulations have not to date been changed. Furthermore, a similar statutory rule had not been adopted with respect to the earlier statutory changes providing that earnings and profits are not reduced by the full amount of accelerated depreciation.

One effect of these statutory changes to the definition of earnings and profits was to change the taxation of corporations filing consolidated returns when a subsidiary is sold. Because earnings and profits of a subsidiary are not reduced by the full amount of accelerated depreciation, the parent corporation's basis in the stock of the subsidiary is not decreased to reflect the full deduction. The parent therefore is now able to sell the stock of the subsidiary without gain (even though the untaxed income is retained by the subsidiary) or with an artificial loss (for example, if threre has been a dividend distribution of any part of the tax-free income, or if the subsidiary's losses have sheltered other income of the parent). The Tax Court, holding that the present consolidated return regulations govern the outcome unless they are changed, has refused to entertain the Internal Revenue Service's position that the present situation creates a benefit similar to a "double deduction." *Woods Investment Company* v. *Commissioner,* 85 T.C. 274 (1985).

A similar benefit may exist outside of the consolidated return context in the case of items not covered by the 1984 changes (e.g., accelerated depreciation). A parent corporation can withdraw as a dividend subsidiary earnings that have not borne tax due to the deductions. The dividend is not taxed to the parent because of the dividends received deduction; and does not reduce the parent's basis in the stock of the subsidiary. The subsidiary might then be sold without tax on the economic gain retained by the parent.

Possible Proposals

1. The parent's basis in stock of a subsidiary with which it files a consolidated return could be adjusted only to the extent the subsidiary's basis in its assets is adjusted (e.g., the parent's basis with respect to deferral items could be adjusted only to the extent of recognized gain or loss).

2. Congress could explicitly apply the rule adopted in 1984, for corporations owning at least 20 percent of a subsidiary, to the earlier changes to the definition of earnings and profits for other deferral items (such as accelerated depreciation) adopted prior to 1984, and clarify the immediate impact of the changes on corporations filing consolidated returns.

Pros and Cons

Arguments for the proposals

1. The proposals would eliminate an unintended effect of prior legislation and would prevent what is in effect a double deduction. The proposals would thus properly measure the amount of gain or loss on the disposition of stock in a subsidiary. The current situation is an anomaly in the operation of the consolidated return regulations that was created by legislation enacted for other purposes.

2. For corporations not filing consolidated returns, it is appropriate to provide similar earnings and profits rules for all deferral items, including accelerated depreciation. Congress should apply the statutory rules for other items to this item, to prevent attempts to use the dividends received deduction, outside of consolidation, to withdraw untaxed earnings from a subsidiary tax-free prior to sale without any corresponding basis reduction in the stock of the subsidiary.

Arguments against the proposals

1. The consolidated return regulations should be within the province of the Treasury Department, and a legislative solution to the treatment of corporations filing such returns is inappropriate.

2. Accelerated depreciation should be treated differently from other deferral items where corporations are not filing consolidated returns.

c. Limit consolidated return pass-through

Present Law

Under present law, corporations may file consolidated tax returns if they are members of an affilated group of corporations. In general, a parent and a subsidiary corporation are members of an affiliated group for this purpose if the parent corporation owns stock of the subsidiary possessing at least 80 percent of the total voting power and value of all the subsidiary stock (excluding certain nonvoting preferred stock).

Under the consolidated return regulations, the consolidated tax return of a parent corporation and an affiliated subsidiary generally allows 100 percent of a subsidiary's losses to offset the parent's income, or, conversely, allows 100 percent of a subsidiary's income to be offset by the parent's losses, even though the parent may own less than 100 percent of the subsidiary's stock (other than excluded non-voting preferred stock). However, the parent corporation generally adjusts its basis in the subsidiary common stock downward only for its allocable portion of deficits in subsidiary earnings and profits (reflecting its share of common stock). No deficits are allocated to preferred stock and no downward basis adjustment is required with respect to preferred stock held by the parent. Upward basis adjustments are made to both common and preferred stock of the parent, but only for the parent's allocable portion of earnings and profits (based on its actual stock ownership).

Under these rules, for example, a parent corporation can own 80 percent of the value and vote of a subsidiary corporation's stock, (or an even lower percentage if nonvoting preferred stock is owned by others) and can utilize 100 percent of the subsidiary's losses to offset its income. However, a downward basis adjustment is required only for the parent's share of losses based on its actual stock ownership. Furthermore, no downward basis adjustment is required with respect to the parent's preferred stock, even though a large part of the vote and value that the parent owns may be in the form of nonvoting preferred stock. The parent thus may be able to sell stock without gain where basis is not reduced.

Also, a parent with losses can own less than 100 percent of a subsidiary and can shelter 100 percent of the subsidiary's income with its losses, even though the subsidiary's income is largely paid to others (for example, other shareholders owning nonvoting preferred stock).

Possible Proposals

1. If the affiliated group owns less than 100 percent of the stock of a subsidiary, require separate return treatment of the percentage of the subsidiary's income or loss attributable to the percentage

that is not owned by the group. (For example, in the case of income there could be consolidated return treatment only of the portion of income corresponding to the current rules for determining the parent's allocable portion of earnings.)

2. Require basis reduction with respect to preferred stock as well as with respect to common stock to the extent of deficits in subsidiary earnings and profits.

3. If the affiliated group owns less than 100 percent of the stock of a subsidiary but consolidates 100 percent of the subsidiary loss, require a downward basis adjustment in the full amount of the loss claimed by the group.

Pros and Cons

Arguments for the proposals

1. A corporation should not be able to offset its income or losses with income or losses of another corporation that are not economically borne by the first corporation.

2. A corporation that effectively controls another corporation may be indifferent as to what percentage of its investment is in the form of common rather than preferred stock. Permitting different basis adjustment rules for preferred stock than for common stock invites the tax-motivated manipulation of capital structure.

3. If the affiliated group consolidates 100 percent of a subsidiary loss but owns less than all the stock, basis should be reduced to reflect the loss the group has actually claimed. Otherwise, the group may purchase the losses of other shareholders and may inaccurately measure gain when stock is sold.

Arguments against the proposals

1. It may be administratively difficult to determine what percentage of income or loss is economically allocable to different classes of stock.

2. Preferred stock may bear less risk of loss than common stock and it may therefore be inappropriate to reduce the basis of preferred stock for deficits in earnings and profits in the same manner as in the case of common stock.

3. If the affiliated group consolidates 100 percent of a subsidiary loss but owns less than all the stock, any basis adjustments should take account of any compensating payments and of any excess income that is consolidated.

d. Debt financing and corporate acquisitions

Present Law

In general, corporate earnings distributed as dividends on equity are taxed at both the corporate level (when earned by the corporation) and at the shareholder level (when distributed). By contrast, corporate earnings distributed in the form of interest on corporate debt bear no corporate level tax because interest is deductible. The Code thus creates a tax incentive to replace equity financing with debt financing to the extent this can reduce corporate taxes.

Some corporations may seek to accomplish this result through their initial capital structure. In other cases, a corporation may substitute debt for equity in a recapitalization, or may borrow and distribute the proceeds of the borrowing to shareholders. The substitution of debt for equity can also be accomplished in an acquisition in which the company is acquired with the use of significant amounts of debt incurred at the corporate level (a "leveraged acquisition").

It is frequently difficult to distinguish debt from equity and numerous common-law factors are considered in making this distinction under present law. These factors include whether there is a contract right to repayment of a specified amount at a specified date and whether there is a reasonable economic expectation of such repayment. Debt to equity ratios, degree of subordination of the debt, and potential for upside equity participation are considered along with other items.

Section 385 of the Code, enacted in 1969, gave the Treasury Department authority to write regulations distinguishing corporate debt from equity. Although several different sets of regulations have been proposed, all have been withdrawn without being adopted.

Section 279 of the Code denies corporate interest deductions on certain indebtedness incurred to acquire stock or substantially all the assets of another corporation. In general, that section denies a deduction for interest exceeding $5 million on corporate acquisition indebtedness if (1) the debt is subordinated to claims of trade creditors or to substantial unsecured debt, (2) the debt is directly or indirectly convertible, and (3) either the debt equity ratio exceeds 2 to 1, or the projected earnings do not exceed 3 times the annual interest.

Under present law, a corporation must recognize gain at the corporate level when it realizes the value of its appreciated property by distributing such property to its shareholders. However, a corporation does not generally recognize gain when it realizes the value of its appreciated property by borrowing against the unrealized appreciation and distributing the proceeds to shareholders. This permits the removal of asset value from corporate solution through the substitution of debt for equity frequently without any current corporate level tax.

If the assets of a corporation are purchased, the corporation recognizes gain and the purchaser obtains a stepped-up fair market value basis for the assets. However, if the stock of a corporation is purchased, there is no corporate-level recognition of gain on the underlying assets, and the assets retain a carryover basis without any step-up to fair market value.

Distributions of appreciated property are generally taxed at the corporate level. However, certain divisive distributions of appreciated corporate stock are tax-free under section 355 of the Code. Generally, that section requires that the stock that is distributed not be acquired by the distributing corporation within 5 years in a taxable transaction. Also, the distribution must not be a device for the distribution of earnings and profits. There is no specific requirement that the recipient have held the distributed company, directly or indirectly, for any specified period of time before or after the distribution. For example, a new shareholder who recently acquired the distributing corporation in a taxable transaction could still receive a qualified section 355 stock distribution. Similarly, following a section 355 stock distribution, recipient shareholders might in some circumstances attempt to sell some or all of their stock if the possibly subjective standards for tax-free treatment (including the device test) are arguably satisfied.

Possible Proposals

1. Codify a series of rules to distinguish debt from equity, based on some or all of the common law standards. Require corporations to treat as stock those instruments that purport to be debt but that do not satisfy the codified rules for classification as debt. Special rules could be provided in the case of acquisitions or other specified transactions; for example, section 279 could apply to stock acquisitions if any one (rather than all three) of its conditions were met.
2. Impose a limitation on the amount or percentage of earnings on future investment that can be deducted as interest.
3. Deny deductions for interest on corporate debt to the extent the proceeds replace equity. This approach could be limited to cases in which certain other conditions are satisfied, such as a high debt equity ratio, a high interest rate, or other factors suggesting a significant risk or market concern that principal might not be repaid.
4. Require recognition of corporate level gain to the extent corporate level debt is incurred in excess of corporate level underlying asset basis.
5. Require recognition of corporate level gain in a stock acquisition as it is in an asset acquisition.
6. Permit nonrecognition in a divisive distribution of corporate stock only if the stock distributed is directly or indirectly owned by the distributee shareholders for a specified period of time (e.g., 5 years) before or after the distribution.

Pros and Cons

Arguments for the proposals

1. The Code should not encourage the structuring of investment as debt as a means of avoiding corporate level tax. Excessive leveraging reduces corporate flexibility and increases the risk of insolvency.

2. Debt incurred in the context of an acquisition or redemption may be particularly likely to be unhealthy for the corporation. Though section 279 of present law applies to acquisitions, the combination of factors required to trigger that section is readily avoidable and the provision is widely regarded as ineffective. New owners that do not place their own capital or employment significantly at risk may be particularly willing to incur substantial amounts of debt and resell their stock taking advantage of any immediate increase in share prices, for example, due to reduction of corporate taxes.

3. Corporations should not be permitted to distribute corporate asset value to shareholders without any current corporate level tax, thus removing assets from the corporate level tax base, and replacing the value with debt that reduces subsequent corporate tax.

4. Some observers argue that the acquisition of corporate stock and the acquisition of the underlying assets should be treated similarly for tax purposes. It is appropriate to require recognition of corporate level gain in a stock acquisition in the same manner as in an asset acquisition.

5. The rules permitting tax-free distributions of corporate stock were intended to apply in cases where there was a mere readjustment of a shareholder's continuing interest in a corporation in modified form. This rationale is not present where the shareholder has recently acquired its interest in the distributing corporation through a taxable acquisition, or where the shareholder sells the distributed stock without having held it for a substantial period of time.

6. The threat of acquisitions distracts corporate management from the most efficient management of the corporation. Acquirors frequently do not enhance corporate efficiency but merely resell pieces of the corporation in a manner that can cause disruption of effective management and dislocation of employees.

Arguments against the proposals

1. It may be difficult to create an effective mechanism for distinguishing debt from equity. Many of the existing common law factors are manipulable so that similar economic consequences can be characterized either as debt or as equity. "Bright-line" tests based on such factors might remain manipulable. To the extent they are not, they may unfairly disadvantage corporations that could benefit economically from borrowing.

2. Restricting interest deductions solely in the context of an acquisition fails to account for the fact that existing management may seek to increase corporate level debt as an anticipatory defensive mechanism or for other purposes. A new owner with potentially more efficient management should not be precluded from obtaining the same tax benefits an old owner could obtain.

3. Restricting interest deductions solely in context of an acquisition favors large potential purchasers, who do not need to borrow, over smaller, possibly more efficient purchasers. Similarly, corporate acquisitions should not be discouraged since new owners and new management may be more efficient than the old owners and management.

4. Corporations should not be precluded from maximizing stock values by incurring debt or replacing equity with debt. Corporate interest expense is a cost of doing business and is properly deductible in computing taxable income.

5. Requiring recognition of corporate level gain in the case of a stock purchase imposes too heavy a burden on acquisitions; moreover, corporate level tax will be collected at some point in the future since the assets in cororate solution retain a carryover basis.

6. Divisive corporate distributions should not be subjected to a heavier tax burden merely because of a recent acquisition of the parent corporation, or a subsequent sale of the distributed stock of a type that would not violate present law section 355.

e. Stock redemptions

Present Law

If a corporation distributes earnings as a dividend, individual shareholders pay tax on the full amount of the distribution at ordinary income tax rates. If instead the distribution takes the form of a nonprorata redemption, the recipient may claim that the amount received is taxed as if a portion of the stock were sold; thus, the amount received is treated as taxable income only to the extent it exceeds the basis of the stock surrendered. In some circumstances, a taxpayer receiving a distribution may take the position that "sale" treatment applies even though the recipient still retains a significant portion of its prior stock interest in the corporation.

Generally, a stock dividend is taxable income to a stockholder who had the option of receiving cash instead of stock. However, in the case of certain redemptions, shareholders who do not surrender stock but increase their interest in the corporation may not treat their increased stock interest as the equivalent of a taxable stock dividend.

If a corporation makes a dividend distribution to its shareholders, the shareholders are taxed on the full amount of the distribution (unless they are corporate shareholders eligible for the dividend-received deduction). The corporation does not recognize any gain on appreciation in its retained assets.

If a corporation makes a liquidating distribution to its shareholders, all of its inside asset gain is recognized since the appreciated assets are distributed however, the shareholders pay tax on the amount distributed only to the extent it exceeds their basis in their stock.

If a corporation redeems its stock in a transaction that is not treated as a dividend to the shareholders, the shareholders recognize gain only to the extent the amount received exceeds their stock basis. The corporation does not recognize gain on appreciation in its retained assets.

There is an exception to the general rule that a corporation recognizes gain on a liquidating distribution, in the case of certain distributions to a controlling corporate shareholder (an 80-percent distributee). By contrast, a nonliquidating distribution to such a distributee would cause the distributing corporation to recognize gain.

Possible Proposals

1. Treat the full amount of a distribution to an individual shareholder who does not terminate his or her interest as taxable income, whether or not some stock is surrendered in connection with the distribution.

2. Some commentators have suggested treating non-pro rata redemptions as if the amount of the distribution had been distributed as a dividend, pro rata to all shareholders, followed by sales among the shareholders.

3. Require recognition of a portion of corporate level built-in gain in the case of any non-pro rata redemption.

4. Treat liquidating distributions to a corporate 80-percent distributee that are not taxed under present law in the same manner as nonliquidating distributions so that gain is recognized to the distributing corporation. Such gain could be deferred in the case of a distribution to a parent corporation filing a consolidated return with the distributee, until triggered by a subsequent disposition or other event under the consolidated return regulations.

Pros and Cons

Arguments for the proposals

1. Present law distinctions between dividends and "sales" of stock by shareholders to their corporations may be artificial in many cases. Some commentators have suggested that the increase in redemptions as a form of distribution may involve tax motivations.

2. If a corporation distributes property from the corporate tax base, the distribution should be taxed to the recipient in full unless the recipient terminates its interest in the corporation so that its actual net gain or loss from the investment can be computed.

3. Shareholders who have the option of receiving cash or increasing their interest in the corporation should be treated as if they received a taxable stock dividend, regardless of the form of the distribution.

Increases in value at the corporate level, which cause increases in value to the shareholders, should be taxed in full when realized. If shareholders do not pay tax on the full amount of a distribution because it is structured as a "sale" of their stock to the corporation, the corporation should pay a proportionate share of the tax it would have paid if in fact all the shareholders had "sold" all their stock to the corporation in a liquidation.

5. Liquidating distributions should not be treated more favorably than nonliquidating distributions under the Code.

Arguments against the proposals

1. Shareholders desiring cash might avoid the shareholder-level tax proposals by either surrendering all of their stock or by selling a portion of their stock to a third party who then surrenders it.

2. Treating non-pro rata redemptions as dividend distributions followed by sales among shareholders requires unduly complex administrative determinations of the proper basis adjustment to the stock of remaining shareholders and could not be enforced without burdensome corporate reporting requirements.

3. Treating non-pro rata redemptions in part as dividends to remaining shareholders would tax such shareholders when they have not received any cash but have merely increased their stock interest.

4. Requiring a corporation to recognize gain on assets that are still retained in corporate solution is not appropriate, regardless of whether shareholders pay tax on the full amount of a distribution. That "inside" gain will be recognized later if appreciated assets are sold or distributed.

5. A liquidating transfer within a corporate group is not an appropriate occasion for the recognition of gain.

f. Tax benefit mergers

Present Law

Generally, the Code prohibits the direct sale of tax benefits from one corporation to another. For example, deductions for net operating losses and built-in losses cannot be sold. Section 269 of the Code seeks to discourage mergers designed principally for tax purposes. In addition, sections 382 and 383 and the consolidated return rules generally seek to prevent new owners from using the target's tax benefits to reduce taxes on income exceeding a specified return on the value of target at the time of its acquisition.

In a bankruptcy, a corporation may elect to be subject to a rule under which its loss carryforwards are reduced by 50 percent of the excess of the debt cancelled in the proceeding over the fair market value of the stock given to creditors in exchange.

Section 338 of the Code permits a corporation that acquires the stock of another corporation to treat the transaction as a purchase of the underlying assets; however, losses of the purchasing corporation may not be used to offset any of the built-in gain on the acquired assets.

Nevertheless, there are a number of acquisition techniques through which taxpayers may attempt to claim the use of tax benefits that could not otherwise be used.

For example, although section 382 of the Code generally limits the acquisition of losses, including built-in losses, the limitations of that section do not apply to built-in depreciation deductions. The consolidated return regulations do limit the use of an acquired corporation's built-in depreciation deductions against income of other members of the group, but not against income of the acquired corporation itself. A profitable acquiring company may, subsequent to the acquisition of a company with substantial built-in depreciation deductions, attempt to transfer some of its income-producing assets to the target in an attempt to avoid the consolidated return rules.

As another example, a loss corporation may acquire a profitable company or a company with built-in gains and seek to use its losses without limitation against the income or built-in gains of the target. To the extent the loss company can shelter the cash-flow from the target's assets or asset sales with its losses, it may be able to offer a better price than a competing bidder in some circumstances.

A loss company that has no significant assets that could generate income may attempt to acquire a profitable target through the use of preferred stock as a financing mechanism, with the target's own income or assets effectively providing the funds for the acquisition.

A loss company may also attempt to act in effect as a conduit for the sale of a corporation with substantial built-in gain assets. A loss company may acquire the stock of the other company and take the position that the assets can then be sold to a new buyer without corporate level tax (claiming that the gain on the sale of the assets is offset by its losses), while the new buyer obtains a stepped-up, fair market value basis. The judicially developed step-transaction doctrines of present law may not be adequate to deter such transactions.

Possible Proposals

1. Subject built-in depreciation to the built-in loss rules of section 382 of the Code.
2. Require the loss carryforwards of a corporation in bankruptcy to be reduced by the full amount of the excess of the debt cancelled in the proceeding over the fair market value of the stock given to creditors in exchange.
3. Prevent loss corporations from using their losses to shelter any built-in gains of an acquired company.
4. Prevent loss corporations from using losses to shelter gains or income from (a) property the purchase of which is effectively financed by preferred stock, or (b) property that is resold (possibly other than in the ordinary course of business) without having been held, subject to risk of loss, for a substantial period (*e.g.*, at least 5 years).

Pros and Cons

Arguments for the proposals

1. Built-in depreciation deductions should be treated the same as other built-in losses and should be subject to the limitations that apply under section 382 when more than 50 percent of the stock of a loss corporation is acquired.
2. Cancellation of creditors' claims should be treated as a benefit reducing prior losses, in the case of a bankrupt corporation just as it would be for other corporations.
3. Loss corporations should not have a competitive advantage over other corporations seeking to acquire businesses and should not be able to act as indirect conduits for the sale of businesses.

Arguments against the proposals

1. Subjecting built-in depreciation to the loss limitations of section 382 would be administratively complex. Although the existing consolidated return regulations may theoretically involve similar complexity, they may not as a practical matter have come into play in many cases.
2. Corporations in bankruptcy should not be subject to any greater restrictions on the future use of losses than under present law, since the use of such losses may assist their future recovery.
3. Loss corporations should not be restricted in obtaining the benefit of their losses against any other income, or in marketing their losses to shelter gains or income, including income that may accrue to the economic benefit of another party.

g. Limit sales of losses using preferred stock

Present Law

A corporation with net operating losses may not sell those losses directly and, if more than 50 percent of its stock (not counting certain nonvoting preferred stock) is acquired, its use of losses in the hands of the new shareholders is limited under section 382, as amended by the Tax Reform Act of 1986. Furthermore, the legislative history of the Act indicates that a loss corporation may not transfer its losses indirectly by participating as a partner in a partnership in which it effectively sells its losses to other partners.

However, a loss corporation or its consolidated subsidiary may attempt in effect to sell its losses by issuing new nonvoting preferred stock to corporate shareholders that are eligible for the dividends received deduction. So long as the issuing corporation has sufficient earnings and profits to cover the dividends, the recipient coporate shareholder pays tax on the dividends at a maximum rate of 6.8 percent, due to the dividends received deduction. At the same time, the payor corporation may be paying no tax on the earnings distributed, because the loss carryovers of the loss company shelter taxable income (earnings and profits for dividend purposes can exist without taxable income).

A loss company can thus sell its losses, for example, by issuing preferred stock to corporate shareholders at a favorable dividend rate that essentially compensates the issuing corporation for the use of its losses to shelter the income that supports the dividend payments.

Because nonvoting preferred stock generally is not counted for purposes of determining whether more than 50 percent of a corporation's stock has been acquired under section 382, a loss corporation can effectively transfer an unlimited amount of its earnings to nonvoting preferred shareholders for new capital against which its losses are used.

Such transactions are also facilitated because nonvoting preferred stock does not generally count for purposes of determining whether a parent corporation owns 80 percent of the stock of a subsidiary. Thus, the two companies may be able to file consolidated returns even though a large part of the value of the subsidiary is accounted for by preferred stock not owned by the parent. Some loss corporations thus have created subsidiaries that receive a substantial amount of new capital in the form of nonvoting preferred stock issued to investors who might be reluctant to invest directly in the parent loss corporation. The taxpayers assert that the earnings on the subsidiary's assets, which provide dividends to the investors, can be sheltered by the parent's losses on a consolidated return. Moreover, present law rules permit but do not require the subsidiary's earnings and profits to be reduced by the amount of taxes it would owe but for the use of the parent's losses. Thus, earnings and profits are available in the subsidiary to support "dividend" treatment of distributions on the preferred stock.

Possible Proposals

1. Deny the use of loss carryovers to offset income used to pay dividends on certain preferred stock—for example, stock that is issued to outside investors and that is not counted for purposes of determining whether there has been an ownership change or that is not counted for purposes of determining whether the corporations may file consolidated returns.
2. Require nonvoting preferred stock to be counted for purposes of determining whether more than 50 percent of the value of the company has been acquired if this would trigger the loss limitations of section 382 of the Code.
3. If a loss corporation is affiliated with another corporation that issues nonvoting preferred stock, do not permit consolidation of the losses unless the nonvoting preferred stock is counted for consolidation purposes (*e.g.*, if the loss company is the parent, it must own 80 percent of the nonvoting preferred stock of the subsidiary). Alternatively, either require separate return treatment of the income used to pay dividends on the nonvoting preferred stock or reduce the earnings and profits of the profitable company by an amount equal to the taxes it would have owed without the affiliate's losses.

Pros and Cons

Argument for the proposals

Corporations with loss carryovers should not be able to sell those losses without limitation to new investors through the use of nonvoting preferred stock. To the extent the net operating loss limitations are intended to prevent new owners from using prior corporate losses to offset a return on the new investor's new capital, the rules are not fully effective under the present law approach to nonvoting preferred stock. Furthermore, the tax system should not provide a double benefit to new investors by permitting both the use of a prior net operating loss and the dividends received deduction.

Argument against the proposals

The existing transferability of losses through the use of preferred stock assists loss corporations in raising capital. Loss companies should not be disadvantaged if they issue preferred stock rather than debt.

h. Limitations on net operating loss carryforwards of corporation following worthless securities deduction by shareholders

Present Law

A deduction is allowed for any loss sustained during the taxable year as a result of securities held by the taxpayer becoming worthless. It has been held that, notwithstanding the fact that a worthless stock deduction has been claimed by parent corporation with respect to stock of a nonconsolidated subsidiary, the net operating loss carryforwards of the subsidiary survive and may be used to offset future income of the subsidiary. *Textron, Inc.* v. *United States,* 561 F.2d 1023 (1st Cir. 1977). In *Textron,* the parent provided a portion of the funds used by the subsidiary to acquire the business responsible for generating this income. Use of a subsidiary's losses following a worthless securities deduction has been denied to the parent corporation, however, where its nonconsolidated subsidiary was subsequently liquidated into the parent in a section 332 liquidation. *Marwais Steel Co.* v. *Commissioner,* 354 F.2d 997 (9th Cir. 1965), *aff'g* 38 T.C. 633 (1962). The court in *Marwais Steel* reasoned that to allow the parent to use the subsidiary's losses would permit it to claim two deductions for a single economic loss.

Loss carryforwards of a corporation are limited if there is a more-than-50-percent change in the ownership of its stock during the relevant testing period. The amount of losses that may be used annually to offset post-change income of the corporation is equal to a prescribed rate of return on the net value of the corporation at the time of the change of ownership.

Possible Proposals

1. Provide a rule that, if a worthless securities deduction is claimed by persons holding a specified percentage of a corporation's stock, its net operating loss carryforwards and other tax attributes are extinguished. This could be accomplished, for example, by treating the corporation's stock as having been sold to an unrelated party for purposes of the rules limiting the use of losses following an ownership change. Thus, if worthless stock deductions were claimed with respect to more than 50-percent of a corporation's stock during the testing period, net operating loss carryovers of the corporation arising prior to the change generally could not be used to offset the corporation's post-change income.

2. Alternatively, provide that a subsidiary's tax attributes are extinguished if a worthless securities deduction is claimed by an 80-percent-or-more parent corporation (whether or not the subsidiary files a consolidated return with the parent).

Pros and Cons

Arguments for the proposals

1. The premise for the worthless securities deduction is that the shareholder's loss has been realized to the same extent as if there had been an actual disposition, even though the shareholder still technically owns the stock. Consistent with this premise, use of the attributes of the issuing corporation should be limited to the same extent as if an actual disposition had occurred.

2. Present law in effect allows the same economic loss to be deducted twice, since the net operating losses of a corporation are also reflected in the loss inherent in its stock.

3. Present law elevates form over substance to the extent it extinguishes the subsidiary's tax attributes if the subsidiary is liquidated into the parent following the worthless stock deduction, but not if the separate status of the subsidiary is formally preserved, even if the subsidiary's post-worthlessness income is generated by assets provided by the parent. These situations are economically identical, and the tax treatment should be the same.

4. Since no duplication of losses generally occurs in a consolidated return context, such duplication should not be allowed to occur in the case of similarly situated corporations not filing a consolidated return.

Arguments against the proposals

1.To the extent there is a double deduction of what is essentially the same economic loss, this is merely a function of the two-tier system of taxing corporate operations, under which corporate-level gains as well as losses are duplicated at the shareholder level.

2. Application of the rules limiting loss carryforwards following a change of ownership is inappropriate in these circumstances. There has been no change in the beneficial ownership of the stock, and hence no transfer of the benefit of the corporation's losses.

3. The separate status of a subsidiary corporation should be respected for tax purposes, even where it is 80-percent or more controlled.

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i. Deemed dividends to corporate shareholders

Present Law

If persons who directly or indirectly control each of two corporations sell the stock of one to the other, the transaction is not treated as a sale but can be recharacterized as a dividend. However, the results are not exactly the same as if there had been an actual dividend distribution. Instead, there are various "deemed" consequences. The dividend is deemed to come first from the earnings and profits of the purchasing corporation and then from the earnings and profits of the corporation whose stock is sold. The stock purchased, in the hands of the acquiring corporation, has a basis equal to its basis in the hands of the selling person and is deemed to have been received as a capital contribution. Specified attribution rules apply for purposes of determining whether a person directly or indirectly controls the two corporations. Under these rules as interpreted in IRS revenue rulings, two corporations that are under common control can be deemed to control one another in some circumstances, even though one may own no stock in the other.

Although the special rules were enacted to prevent individual shareholders (who are not eligible for the dividends received deduction) from "bailing out" earnings from a controlled corporation at capital gains rates, rather than as ordinary dividend income, by using the form of a sale of stock, the rules apply not only to individual shareholders but also to corporate shareholders. Corporations may prefer dividend treatment to sale treatment because the dividends received deduction results in a maximum tax rate of 6.8 percent on dividends received from another corporation. Also, in many cases involving common control, there is no tax because the dividend is either eligible for the 100-percent dividends received deduction applicable within an affiliated group or is excluded from income under the consolidated return regulations.

The special rules can provide significant tax planning opportunities to corporate shareholders. Not only can such shareholders receive dividend treatment if that is more preferential than sale treatment; the results may also be significantly more favorable than if an actual dividend had been paid, due to the "deemed" flows of earnings and profits. Under the consolidated return regulations, for example, an increase in the earnings and profits of a subsidiary can create a corresponding increase in the parent's basis in the stock of the subsidiary. Although a distribution of earnings and profits generally reduces the parent's basis in subsidiary stock, this does not occur if the distribution is not made to a corporation that actually owns stock in the distributing company. A "deemed" section 304 dividend from a brother to a sister company can thus have the effect of increasing the basis of the stock of the company that is treated as "receiving" the dividend, without reducing the basis of the stock of any other company.

Although since 1984 the Code has taxed a distributing corporation on appreciation in stock it distributes to a controlling corporate shareholder unless the distribution qualifies under the special conditions of section 355, taxpayers have manipulated the rules to claim a tax-free distribution of nonqualifying stock. Also, taxpayers have claimed that the distributing corporation can then be sold without any reduction in its basis for any portion of the assets that were in effect withdrawn tax-free.

Possible Proposals

1. Modify the rules with respect to corporate shareholders so that the results are not better than if the corporations had made actual distributions. For example, if stock is sold by a brother to a sister corporation, require the stock transfer to the treated as if the stock had actually been distributed to the common parent and recontributed to the recipient.

2. Modify the rules of section 304 so that corporate shareholders in control of two corporations who purport to "sell" the stock of one to the other must at least experience a basis reduction in the stock of any subsidiary from which amounts are directly or indirectly withdrawn. Also, require transfers or deemed transfers that are essentially "circular" to be disregarded where appropriate to prevent tax avoidance, including transfers of cash to a subsidiary that is then sold (or that transfers cash to an affiliate that is sold) for a price that repays the cash amount to the seller.

Argument for the proposals

Corporations should not be permitted to use a provision that was directed at "bail-outs" by individual shareholders to obtain better tax results than they could have obtained by either an actual sale or an actual distribution.

Argument against the proposals

The present-law rules with respect to intercorporate distributions of subsidiary stock are too harsh, and it is appropriate for taxpayers to be able to use section 304 to obtain more favorable results.

j. Affiliation rules for Alaska Native Corporations

Present Law

Under present law, Native Corporations established under the Alaska Native Claims Settlement Act (43 U.S.C. 1601 et seq.) (and 100-percent subsidiaries of such corporations) are entitled to file consolidated returns if they qualify under the more liberal affiliation rules formerly in effect for all corporations before the Deficit Reduction Act of 1984. These affiliation rules are in effect for such corporations for taxable years beginning before 1992.

During the transitional period, eligibility of such corporations for affiliation may be determined solely on the basis of a literal application of the statutory requirements. No provision of the Code or principle of law may be applied to deny the benefit of any losses or credits of such corporations to the affiliated group of which the corporation is a member. Accordingly, the benefit of such losses and credits may not be denied, for example, by application of the assignment of income doctrine, section 269 (relating to disallowance of deductions or credits following a tax-avoidance motivated acquisition), or section 482 (relating to the Commissioner's authority to reallocate income, deductions, or credits among commonly controlled businesses).

Possible Proposals

1. Limit utilization of losses of Alaska Native Corporations to loss carryforwards existing on the date of enactment of the 1986 Act, plus certain post-enactment losses (*e.g.,* those incurred in taxable years beginning before January 1, 1988).

2. Deny carrybacks of Native Corporation losses to 1986 or 1987 to the extent such losses would offset income generated by a corporation that would not be eligible for affiliation in the absence of the special affiliation rules.

3. Prohibit losses from being used against income that is assigned to a Native Corporation subsidiary, as opposed to income that is attributable to assets of or services performed by the subsidiary.

Pros and Cons

Arguments for the proposals

1. Present law permits the unrestricted sale of future losses, as well as losses existing at the effective date of the 1986 Act, by Alaska Native Corporations. This provides an undue benefit from the continued creation of losses.

2. Absent a prohibition against carrybacks of future Native Corporation losses to 1986 and 1987, taxpaying corporations can assign income to the Native Corporation group in those years, when losses are worth between 40 and 46 cents on the dollar, rather than in

the year the losses are incurred when they will be worth only 34 cents on the dollar.

Arguments against the proposals

1. The special affiliation rules, including the rules allowing assignment of income, assure the ability of the Native Corporations to derive the full benefit of their losses at the earliest possible date, generating funds to help the Corporations become self-sufficient.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
Limitations on use of losses of Native Corporations....................	(1)	(1)	(1)	0.1

[1] Gain of less than $50 million.

k. Denial of graduated rates for personal service corporations

Present Law

Under present law, beginning July 1, 1987, corporations are generally subject to a tax at the rate of 34 percent. However, for corporations with a taxable income below $335,000, graduated rates are provided. These rates are 15 percent on taxable income not over $50,000, and 25 percent on taxable income over $50,000 and not over $75,000, with the benefits of these lower rates phased out as taxable income increases from $100,000 to $335,000.

Possible Proposal

The benefits of the graduated corporate rates could be denied to personal service corporations.

Pros and Cons

Argument for the proposal

1. Income from personal services should not receive the benefit of the lower graduated corporate tax rates. Since personal service income may generally be paid as deductible salary to the owner-employees and thereby be taxed once at the owner-employees' tax rate, it is inappropriate to tax it at a lower corporate rate. Other Code provisions treat personal service corporations the same as their owners—*e.g.*, the passive loss rules and the cash accounting provisions.

Argument against the proposal

1. All corporate income should be taxed at the regular corporate rates. The graduated rates were enacted to benefit corporations with lower incomes and should not be limited.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
Eliminate graduated rates for personal service corporations....	0.1	0.1	0.1	0.3

l. Conversion of C corporation to S status

Present Law

In general, gain realized when a C corporation liquidates is subject to corporate level tax. If a C corporation elects to convert to S corporation status and holds assets with a net unrealized "built-in gain" (that is, with a value in excess of basis) at the time of its conversion, the built-in gain is subject to a separate corporate-level tax to the extent it is realized within ten years after the conversion. Although built-in corporate level gain is thus generally taxed as realized over the 10-year period, such gain is not taxed at the corporate level to the extent it is offset by post-conversion losses.

The Internal Revenue Service has stated that the inventory method used by a taxpayer for tax purposes shall be used in determining whether goods disposed of following a conversion to S corporation status were held by the corporation at the time of conversion. Thus, a C corporation using the last-in, first-out (LIFO) method of accounting for its inventory which converts to S corporation status will not be taxed on the built-in gain attributable to LIFO inventory to the extent it does not invade LIFO layers during the ten-year period following the conversion.

Possible Proposals

A C corporation using the LIFO method which elects S corporation status could be required to include in income the LIFO recapture amount (that is, the excess of the inventory's value using a first-in, first-out (FIFO) flow assumption over its LIFO value on the date of the conversion) upon conversion. Full recapture could be required in the year of conversion or applying a FIFO inventory flow assumption, or the income could be spread over some period of time (e.g., five years, ten years). The built-in gain provisions could generally be revised to operate more effectively to measure and tax over a deferred period the corporate level gain existing at the time of conversion.

Pros and Cons

Arguments for the proposals

1. The provision that imposes a separate corporate-level tax on built-in gains may be ineffective in the case of LIFO inventory, since a taxpayer experiencing constant growth may never be required to invade LIFO inventory layers. The LIFO method C corporation thus may, by converting to S status, escape the recapture tax that would have been imposed had there been a liquidation.

2. Under present law, LIFO taxpayers electing S corporation status pay less corporate level tax than FIFO taxpayers, since

LIFO recapture tax that is not paid within the 10 year period is never recovered.

3. The provision dealing with conversion from C to S status should conform more closely to the results that would have occurred in a liquidation.

Arguments against the proposal

1. Built-in gain attributable to LIFO inventory is no different than built-in gain attributable to other types of assets, and should not be subject to harsher rules. Accordingly, if such inventory is not deemed to have been disposed of during the statutory recognition period, no separate corporate-level tax should be imposed.

2. The proposal would dilute the benefit of the LIFO method, the use of which Congress has expressly authorized. If Congress believes that the LIFO method provides unwarranted tax benefits, it should address this problem directly, not by triggering recapture upon a conversion to S status which is not treated as a liquidation for other purposes.

3. It is inappropriate to more closely conform the results of a conversion from C to S status to the results that would have occurred if the corporation had liquidated; this imposes too heavy a burden on a conversion from C to S status.

10. Partnership Provisions

a. Master Limited Partnerships (MLPs)

Present Law

Under present law, a partnership is not subject to tax at the partnership level, but rather, income and loss of the partnership is subject to tax at the partner's level. A partner's share of partnership income is generally determined without regard to whether he receives any corresponding cash distributions. Similarly, partnership deductions, losses and credits are taken into account at the partner level for tax purposes.

The amount of losses that a partner may deduct for a particular year may not exceed the amount of the adjusted basis of his partnership interest (sec. 704(d)), nor may such deductions exceed the partner's amount at risk for the year (sec. 465) in the case of individual and certain closely held corporate partners. The passive loss rule (which, except as provided in regulations, treats a limited partnership interest in an activity as an interest in a passive activity) generally limits deductions from passive activities to the income from all passive activities (or in the case of credits, to the tax liability attributable to passive activities). These rules generally do not limit the use of losses, deductions and credits from a limited partnership's activity to shelter income earned in the limited partnership's activity. Thus, unlike corporate dividend distributions which generally are taxed to the corporate shareholders (regardless of whether income tax was paid at the corporate level), distributions of partnership cash flow can be made to partners on a largely or completely tax-free basis.

Treasury regulations distinguishing partnerships from corporations currently provide that whether a business entity is taxed as a corporation depends on which form of enterprise the entity "more nearly" resembles (Treas. Reg. sec. 301.7701-2(a)). The regulations list six corporate characteristics, two of which are common to corporations and partnerships, and the other four of which are: (1) continuity of life, (2) centralization of management, (3) liability for corporate debts limited to corporate property, and (4) free transferability of interests. The regulations provide that an association is treated as a corporation (rather than a partnership) for Federal income tax purposes if it has more corporate than non-corporate characteristics. Under these regulations, large publicly traded limited partnerships can technically be treated as partnerships rather than corporations, despite the expectation that the partnerships are likely to continue in existence and the fact that the partnerships' limited partners have limited liability, can transfer their interests, and do not participate in management.

Possible Proposals

1. Publicly traded limited partnerships could be treated as corporations for Federal income tax purposes, with a grandfather rule for existing partnership capital. The Administration has expressed support for this proposal. Alternatively, the same treatment could be applied to publicly offered limited partnerships, i.e., those in which interests are offered for sale in a transaction required to be registered with a Federal or State securities regulatory agency.

2. Withholding (or collection of partners' estimated tax liability) could be imposed at the partnership level on partners' shares of income from publicly traded or publicly offered limited partnerships.

3. Publicly traded or publicly offered limited partnerships (or all limited partnerships) could be treated as corporations or non-passthrough entities under the alternative minimum tax, or holders of interests in such entities could be treated as subject to the book income and adjusted current earnings provisions of the corporate alternative minimum tax.

4. Publicly traded or publicly offered limited partnerships could be treated as entities that do not pass through tax losses, deductions or credits to limited partnerships, and net income of the partnership could be treated as portfolio (rather than passive) income to the partners under the passive loss rule.

Pros and Cons

Arguments for the proposals

1. Publicly traded limited partnerships resemble publicly traded corporations in their business functions and in the way their interests are marketed, and limited partners resemble corporate shareholders in that they have limited liability, may freely transfer their interests, generally do not participate in management, and expect continuity of life of the entity for a term necessary to its purposes. Consequently, these types of entities and their holders should be treated similarly for Federal income tax purposes.

2. The availability of passthrough treatment in the form of publicly held interests encourages tax-motivated decisions as to choice of business form, rather than tax-neutral, economically motivated decisions.

3. The availability of elective integration of the corporate and shareholder level tax through the use of publicly held limited partnerships in lieu of corporations is contrary to the express policy determination of Congress to maintain distinct corporate and individual income taxes, and erodes the corporate tax base.

4. The availability of passthrough treatment in the form of publicly held limited partnership interests creates an unintended competitive advantage for certain businesses or industries that are most readily able to conduct business in the form of limited partnerships.

5. Unlike small general partnerships, large or publicly traded limited partnerships are not, in a realistic economic sense, the alter egos of the partners and thus there is little justification for maintaining conduit tax treatment for them.

6. The partnership rules were not designed for publicly traded partnerships; such partnerships may have difficulty complying with the partnership rules, and create audit difficulties stemming from complex, difficult-to-monitor calculations that are applied to hundreds of partners, and place an excessive burden on the administration and collection mechanisms of the tax law.

Arguments against the proposals

1. Under currently authorized Treasury regulations (in effect for over 25 years) that distinguish between partnerships and other entities, as they have been interpreted, the corporate characteristics of publicly traded limited partnerships are generally insufficient to merit routine recharacterization of such partnerships as corporations for Federal income tax purposes.

2. The current system of two levels of tax on corporate income is irrational, and the opportunity to integrate the two levels of tax electively through the use of publicly held limited partnerships should be preserved.

3. The formation of publicly traded limited partnerships by corporations with temporarily highly leveraged assets (e.g., following a leveraged buyout) offers such corporations an opportunity to clear the debt off the corporate books faster by substituting partnership equity for the debt, thus increasing the corporation's stock price to reflect its true net worth.

4. Treating general categories of large limited partnerships as corporations, or as non-passthrough entities, may be unfair in certain instances where the owners of a particular partnership are indeed personally engaged in the partnership's activities and the partnership is substantially their economic alter ego. Further, partners of large partnerships may not be less involved in partnership activities than partners of some smaller partnerships.

5. Publicly traded limited partnerships may have a business utility in only a limited number of contexts, and thus do not represent a significant potential for erosion of the corporate tax base, or a significant contradiction of express Congressional policy to maintain separate corporate and individual tax regimes.

6. Treating certain partnerships differently for regular and for alternative minimum tax purposes could give rise to undue complexity in the administration of the tax law.

b. Partnership allocations

Present Law

Present law provides that a partnership is not subject to income tax, but rather that the partners are separately subject to tax on their distributive shares of the partnership's overall income or loss (and the partnership's separately computed items of income, gain, loss, deduction or credit). In general, if the partnership agreement does not provide as to the partner's distributive share, then his distributive share is determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances). Partnership income, gain, loss, deduction or credit (or items thereof) may be allocated under the partnership agreement, but if the allocation does not have substantial economic effect, then the partner's share is redetermined in accordance with his interest in the partnership.

Treasury regulations describing when an allocation has substantial economic effect provide generally that to have economic effect, an allocation must be consistent with the underlying economic arrangement of the partners, and for the economic effect to be substantial, there must be a reasonable possibility that the allocation will affect the dollar amounts received by the partners, independent of tax consequences. More detailed requirements also apply. Allocation of deductions attributable to nonrecourse debt, for which no partner is personally liable, is permitted (provided that the partnership agreement provides for a chargeback to the partner of the minimum gain attributable to the nonrecourse debt), even though such allocations cannot have economic effect.

The regulations permit allocations that shift over time (e.g., where items are initially allocated to one partner or group of partners, and subsequently are allocated to others). Similarly, items of partnership income may be allocated to a tax-exempt partner (or a partner with a low effective tax rate) at the same time that the corresponding cash flow is distributed to other partners.

Under present law, tax-exempt organizations generally are subject to tax on unrelated business income. In general, income from debt-financed property is treated as unrelated business income. An exception from the unrelated business income tax is provided, in the case of debt-financed real property, provided the property is not leased back to the seller and certain other requirements are met, even if, at the same time, income can be allocated to tax-exempt partners and losses to taxable partners.

The rules relating to partnership allocations do not apply to amounts paid with respect to partnership debt. Thus, although partnership income may be paid out in the form of debt service, such payments are not treated as allocations of income under the partnership agreement. Similarly, fees paid to partners for services are not generally treated as allocations of partnership income.

Possible Proposals

1. Where a partnership has both taxable and tax-exempt partners, the income allocated to the taxable partners could be required not to be less (nor the losses and other tax benefits greater) than the amount allocable in accordance with the taxable partner's interest in the partnership.
2. Arrangements whereby allocations to particular groups of partners change over time (e.g., where initial losses are allocated principally to taxable partners, and later income is allocated to other partners) could be treated as not having substantial economic effect nor being in accord with partners' economic interests in the partnership.
3. Payments on partnership debt held by tax-exempt organizations, and payments to such organizations for services, could be taken into account in determining whether partnership allocations have substantial economic effect. Alternatively, these types of payments could be taken into account regardless of the identity of the payee in determining the substantial economic effect of partnership allocations.
4. Where allocations in the partnership agreement result in allocation of more than a particular percentage (e.g., 35 percent) of partnership losses to taxable partners, and the partnership includes both taxable and tax-exempt (or low effective rate) partners, then allocations that are consistently the same for all items could be required.

Pros and Cons

Arguments for the proposals

1. The large degree of flexibility in partnership allocations under present law is excessive because it allows what is in effect the sale of tax benefits. This directly contravenes policy expressed by Congress in, for example, the repeal of safe harbor leasing in 1982.
2. Allowing partnership allocations that are actually sales of tax benefits causes economically inefficient investment decisions motivated by tax rather than economic factors, and harms the economy.
3. Allowing partnership allocations that are actually sales of tax benefits is unfair, because it permits those who can invest in partnerships to receive tax-free distributions of partnership cash flow, while other taxpayers must generally pay tax on cash they receive.

Arguments against the proposals

1. The partnership rules are designed to provide significant flexibility for partners to arrange their affairs, and rules limiting allocations are contrary to this purpose.
2. Limitations on partnership allocations that do not have substantial economic effect and that may represent mere transfers of tax benefits are already imposed in the Treasury regulations implementing sec. 704(b), and further limitations would be redundant and would add unnecessary complexity to an already complex area.

c. Transactions between partners and partnerships

Present Law

Present law provides that, in general, no gain or loss is recognized by a partnership or its partners when property is contributed to the partnership in exchange for a partnership interest. Gain or loss generally is recognized, by contrast, when property is sold. In cases where there is a transfer of money or other property by a partner to a partnership, and a transfer of property or money by the partnership to a partner that, when viewed together, are properly characterized as a sale or exchange, then the transfers are generally treated as such, and the transferor of the property is treated as recognizing gain (or loss, if any).

It is not completely clear whether present law treats certain types of transactions as nontaxable contributions to a partnership, or as a sale or exchange between the contributor and the partnership. For example, when a person contributes appreciated property, subject to debt, to a partnership in exchange for a partnership interest, and the partnership then uses the proceeds of sales of other partnership interests to pay off the debt encumbering the appreciated property, it is not completely clear that the transaction is equivalent to a transfer of money or other property to the contributing partner.

Possible Proposal

Where encumbered property is contributed to a partnership and proceeds of sales of partnership interests are used to pay the debt encumbering the property, the person who contributed the property could be treated as receiving a transfer of money or other property from the partnership in a taxable sale or exchange.

Pros and Cons

Arguments for the proposal

1. A person such as a corporation that improves its economic position by exchanging debt-encumbered property for an interest in a partnership that promptly pays off the debt with funds contributed by new partners, should be treated for tax purposes as it is treated for financial and economic purposes: as having gained in the transaction.

2. The proposal would treat similarly transactions that are essentially equivalent to each other in substance and differ only in form.

Arguments against the proposal

1. It is inappropriate to raise a tax law obstacle to having taxpayers such as corporations remove liabilities from their books so that

stock prices reflect more accurately the true value of the corporation's business.

2. Making contributions of property to partnerships less attractive from a tax standpoint, e.g., in the case of corporate contributors, takes away one of the means of fending off hostile corporate takeovers, and merely perpetuates the recent wave of takeovers (which has been criticized as not contributing to healthy growth of the economy).

d. Partnership-level income computation

Present Law

Under present law, a partnership is not subject to tax at the partnership level, but rather, each partner's share of separately calculated items and of overall income and loss of the partnership is subject to tax at the partner's level. The partnership agreement may provide for special allocations of items of income, gain, loss, deduction or credit to particular partners, provided the allocation satisfies standards (set forth in Treasury regulations) requiring that special allocations have substantial economic effect. A partnership can thus pass through net income or losses to its partners, or can pass through deductions or other tax benefits to particular partners, and taxable income to other partners. A partner's share of partnership income is generally determined without regard to whether he receives any corresponding cash distributions.

Present law provides several limitations on the deductibility of losses and on other tax benefits passed through partnerships (e.g., the passive loss rule, the at-risk rule, and partnership tax rules limiting partners' losses to their basis in their partnership interests). Under the passive loss rule, activities of limited partnerships are treated as passive activities; except as provided in regulations (which have not been issued), income or loss passed through from limited partnerships is treated as passive. Income from limited partnership activities can consequently be treated as passive and can offset losses that would otherwise be deferred until disposition, under the passive loss rule. Such income-producing limited partnerships have been referred to and publicly marketed as so-called passive income generators.

Possible Proposal

Limited partnerships could be treated as entities that do not pass through tax losses, deductions or credits to limited partners. Net income of the entity would be subject to only one level of tax (at the partner level). Income of the entity would be treated as portfolio (rather than passive) income under the passive loss rule in the hands of the owners of the entity. Alternatively, this proposal could be applied to a narrower class of partnerships (e.g., publicly offered or publicly traded limited partnerships).

Pros and Cons

Arguments for the proposal

1. Limited partnerships that pass through net income can be used to avoid the passive loss limitations, which the Congress just adopted to stop tax shelters and regain public confidence in the fairness of the tax system.

2. Treating publicly offered limited partnerships as subject to one level of tax on distributed net income creates a more level playing field in comparison to other business entities not taxed as corporations.

3. The proposal would prevent erosion of the corporate tax base and solve some of the issues relating to master limited partnerships by making it more likely that at least one level of tax is collected on the income of all types of business entities.

Arguments against the proposal

1. Owners of interests in such entities could still receive tax-free cash distributions, where the entity operates at a tax loss and has no net income that would be taxable to owners.

2. The proposal removes much of the flexibility that the partnership tax provisions were designed to have, and consequently denies limited partnerships the ability to have their tax treatment parallel the complexities of the economic arrangements of the partners.

3. The proposal is not needed because regulatory authority is already provided to treat net income from limited partnerships as portfolio income under the passive loss rule.

11. Depreciation Provisions

a. Determine recovery period of property by reference to 125 percent of lease or other contract term

Present Law

In general, under the Accelerated Cost Recovery System ("ACRS"), property is assigned among recovery classes on the basis of midpoint lives under the prior law Asset Depreciation Range ("ADR") system, as in effect on January 1, 1986. ADR midpoint lives were derived from data on how long taxpayers who provided information held the assets. The Treasury Department is authorized to prescribe new ADR midpoints based on an asset's anticipated "useful" life (rather than "service" life).

Under the alternative depreciation system used for property for which which less generous depreciation is provided, the recovery periods used are also based on ADR midpoint lives. Property that is leased to or used by a tax-exempt person ("tax-exempt use property") is subject to the alternative depreciation system; however, the recovery period used is not less than 125 percent of the lease term if that period is longer than the depreciation period otherwise applicable.

ACRS deductions are allowed only to the owner of property for Federal income tax purposes. Although the determination of ownership is inherently factual, general principles were developed in court cases, revenue rulings, and revenue procedures. These principles focus on the economic substance of a transaction, not its form. Thus, in a purported lease or similar arrangement, the person claiming ownership must show that he has sufficient economic indicia of ownership.

To give taxpayers guidance in structuring leveraged leases (i.e., leases in which the property is financed by a nonrecourse loan from a third party) of equipment, the Internal Revenue Service ("IRS") issued revenue procedures (the "guidelines"). If the requirements of the guidelines were met, the IRS generally issued an advance letter ruling that the transaction was a lease and the lessor would be treated as the owner for Federal income tax purposes. Under the guidelines, the lessor must demonstrate that a remaining useful life of at least 20 percent of the originally estimated useful life of the property is the reasonable estimate of what the remaining useful life of the property will be at the end of the lease term.

Possible Proposal

For purposes of ACRS and all cases to which the alternative depreciation system applies, determine the recovery period of property by reference to the longer of 125% of a lease (or other contract) term or the period that would otherwise apply. For purposes of this rule, include renewal options in the lease (or other contract) term.

Pros and Cons

Argument for the proposal

In general, assets are assigned to ACRS classes by reference to economic lives. At present, the prior-law ADR system is utilized as the best available measure of economic lives, although the Treasury Department is authorized to refine ACRS classifications after additional study of the economic lives. The lessor of an asset cannot satisfy IRS ruling guidelines regarding the definition of a leveraged lease unless the asset's useful life is equal to at least 125% of the lease term. Thus, in the case of an asset that is leased, the lease term provides independent evidence of the asset's minimal economic life. The term for which an asset is used under a service contract or financed provides similar evidence of economic life.

Argument against the proposal

The economic life of an asset is the same whether it is owned or leased by the user. The proposal would provide less generous depreciation for leased assets, and would discriminate against business enterprises that cannot afford to purchase equipment (because rentals would reflect the increased tax cost to the lessor).

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Extend recovery period to 125% of lease or other contract term	0.1	0.2	0.2	0.4

b. Limitations on depreciation deductions for luxury automobiles

Present Law

Depreciation deductions are subject to fixed dollar limitations for luxury automobiles. The limitations are $2,560 for the first taxable year in the recovery period, $4,100 for the second taxable year, $2,450 for the third taxable year, and $1,475 for each succeeding taxable year. The limitations are inapplicable to automobiles that are leased or held for leasing by any person regularly engaged in the business of leasing automobiles. A lessee's deductions for rentals are subject to reduction but only if the lease term is 30 days or more. The surrogate limitation imposed on lessees requires the prescription of special tables by the Internal Revenue Service ("IRS").

Possible Proposal

Impose the limitations for luxury automobiles directly on the owner of leased automobiles.

Pros and Cons

Arguments for the proposal

1. Because the value of a very expensive automobile does not depreciate as quickly as that of a less expensive car, the degree of acceleration under the Accelerated Cost Recovery System ("ACRS") would be greater for an expensive automobile that is leased but not subject to the luxury car limitations. The Congress determined that the investment incentive afforded by the ACRS should be directed to encourage capital formation rather than to subsidize the element of personal consumption associated with the use of expensive automobiles. These observations are equally applicable to automobiles that are leased for personal use; however, the current statute does not reach this case.

2. The imposition of a surrogate limitation on business lessees is inherently more complex than the rule that applies to owners of luxury automobiles. Under the current statute, the IRS is required to prescribe special tables, which provide for varying dollar limitations depending on factors such as the vehicle's fair market value, the number of days of the lease term included in the taxable year, and the amount of business use by the lessee.

Arguments against the proposal

1. The surrogate limitation imposed on lessees is substantially equivalent to imposing a limitation on the lessor.

2. The imposition of a limitation on lessors would result in the payment of increased rentals by all lessees, and would unfairly

burden lessees who do not deduct rentals because the leased automobile is used only for personal purposes.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Limitation on depreciation deduction for luxury autos	([1])	0.1	0.2	0.3

[1] Gain of less than $50 million.

c. Income forecast method of amortization

Present Law

Amortization of intangibles

The Accelerated Cost Recovery System ("ACRS") does not apply to intangible assets. Amortization allowances are available for intangible assets of limited useful life that are used in a business or held for the production of income. Generally, amortization allowances are computed using a straight-line method. Certain income-producing properties, such as motion picture and television films, may be amortized under the income forecast method which allocates costs proportionately to income expected to be produced.

Look-back method for long-term contracts

A taxpayer using the percentage of completion method with respect to a long-term contract is required to determine upon completion of the contract the amount of tax that would have been paid in each taxable year if the income from the contract had been computed by using the actual gross contract price and total contract costs, rather than the anticipated contract price and costs. Interest must be paid by the taxpayer if, applying this "lookback" method, there is an underpayment by the taxpayer with respect to a taxable year. Similarly, under the "lookback" method, interest must be paid to the taxpayer by the Internal Revenue Service if there is an overpayment. The rate of interest for both underpayments and overpayments is the rate applicable to overpayments of tax (i.e., the short-term Federal rate plus 2 percentage points).

Possible Proposal

Require taxpayers using the income forecast method with respect to an item of property to determine at the end of the property's useful life (or, if earlier, at the end of a specified period, such as five years) the amount of tax that would have been paid in each taxable year if the amortization allowance had been computed by using the actual income derived from the property, rather than the forecasted income. Interest would be paid by the taxpayer if, applying this "lookback" method, there is an underpayment by the taxpayer with respect to a taxable year, and interest would be paid to the taxpayer if, applying this "lookback" method, there is an overpayment.

The "lookback" method could also be applied to other methods of depreciation or amortization that are not based on a useful life or recovery period, such as the unit-of-production method.

Pros and Cons

Arguments for the proposal

1. The use of the income forecast method results in the deferral of tax if the forecasted income is less than the actual income derived from the property. Thus, taxpayers have an incentive to underestimate income that will be derived from the property in later years. The "lookback" method generally will recapture any deferral benefit and negate this incentive.

2. The potential tax deferral available under the income forecast method may distort the allocation of capital and reduce economic efficiency.

Arguments against the proposal

1. The "lookback" method may generate additional complexity and uncertainty for the taxpayer, and add to the enforcement burden of the Internal Revenue Service.

2. The application of the "lookback" method at the end of a specified period is arbitrary and may not properly recapture the deferral benefit.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Income forecast method of amortization	(1)	(1)	(1)	(1)

[1] Gain of less than $50 million.

12. Foreign Tax Provisions

a. Title passage source rule and 50-50 production/marketing split

Present Law

The foreign tax credit may eliminate the U.S. tax on "foreign source" income. That credit cannot reduce U.S. tax on "U.S. source" income. Therefore, to calculate the foreign tax credit, every item of income must have a source.

Title passage source rule

In general, income derived from the sale of personal property by U.S. residents is U.S. source. Income attributable to the marketing of inventory property by U.S. residents, however, has its source at the place of sale, generally being where title to the property passes to the purchaser (the "title passage" rule). This title passage rule applies both to all income from the purchase and resale of inventory and to the marketing portion of income from the production of inventory property in the United States and marketing of that property abroad.

Production/marketing split

Income derived from the manufacture of products in the United States and their sale elsewhere is treated as having a divided source. Under Treasury regulations, 50 percent of such income generally is attributed to the place of production, the United States, and 50 percent of the income is attributed to marketing activities and is sourced on the basis of the place of sale (determined under the title passage rule). The division of the income between production and marketing activities must be made on the basis of an independent factory price, rather than on a 50-50 basis, if such a price has been established.

Study of title passage rule

The 1986 Tax Reform Act directs the Treasury Department to study the effect of the title passage rule as it applies in determining the source of the income from the sale of inventory property. That study is to take into account the Act's lower tax rates and Congressional trade concerns; the report arising from that study is due not later than September 30, 1987.

1985 Administration Proposal

Title passage source rule

Under the Administration's 1985 tax reform proposal, adopted by the House bill but not contained in the Tax Reform Act of 1986, the title passage rule would be eliminated and gain from sales of inventory would be sourced in the seller's residence country. An exception to this general rule would apply if the seller maintains a fixed place of business outside the United States and that fixed placed of business participates materially in the sale generating the income. In such a case, marketing income would be sourced in the country where the fixed place of business is located. However, all income from sales to related foreign persons would be sourced in the United States even if the seller maintains a fixed place of business in another country.

Production/marketing split

The Administration did not propose a specific change in the 50/50 formula for allocating income that arises from a combination of production and marketing activities to production and marketing, respectively. However, it did indicate that a fixed percentage allocating a greater portion of income to production than to marketing might be appropriate.

Pros and Cons

Arguments for the proposals

1. The foreign tax credit's purpose is to prevent double taxation. Income that has a foreign source under the title passage rule is not likely to be taxed by any foreign country, so U.S. taxation of that income would not defeat the purpose of the foreign tax credit and would not create double taxation.
2. The source rules for sales of personal property should reflect the location of economic activity generating the income. Determination of source under the title passage rule and attribution of 50 percent of income from production and marketing to the place of marketing do not reflect the economic activity generating the income.
3. The Tax Reform Act's rate reductions tend to create excess foreign tax credits for U.S. taxpayers. Those excess foreign tax credits generated on income unrelated to sales of inventory property should not shelter income from sales of inventory property from tax.
4. Export incentives should be targeted to all exporters, not just to exporters that have excess foreign tax credits that they can use to shelter export income from U.S. tax.

Arguments against the proposals

1. The current rules serve as a valuable export incentive and help promote international competitiveness. The tax burden on export income would increase if Congress adopted the 1985 Administration proposal. At a time of large U.S. trade deficits, it would be unwise to reduce any export incentive.
2. The current rules have worked well for many years.
3. The current rules sometimes provide a result that is consistent with the economic activity test.
4. Congress should delay consideration of any changes to the current rules until the completion of the Treasury Department's study.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
Repeal title passage source rule	0.3	0.7	0.7	1.7

b. Income from runaway plants

Present Law

U.S. persons that conduct foreign operations through a foreign corporation generally pay no U.S. tax on the income from those operations until the foreign corporation pays a dividend to its U.S. owners. The foreign tax credit may reduce or eliminate the U.S. tax on those dividends, however.

Deferral of U.S. tax on income of a U.S. corporation's foreign subsidiary is not available for certain kinds of income, including "foreign personal holding company income" (such as interest and dividends, net gains from sales of stock and securities, and some rents and royalties), certain sales and services income, and certain other kinds of tax haven income.

Possible Proposal

Congress could repeal deferral for (that is, impose current tax on) income from "runaway plants," that is, income that a U.S. corporation's foreign subsidiary earns from manufacturing goods for use or consumption in the United States. This income, as well as allocable interest and royalties paid by the foreign subsidiary, would be subject to a separate foreign tax credit limitation, so that, for example, foreign taxes imposed on other income could not offset the U.S. tax on this income.

Pros and Cons

Arguments for the proposal

1. When a U.S. enterprise manufactures goods for the U.S. market, it should be subject to the same tax burden whether that manufacturing takes place abroad or in the United States.

2. The deferral or elimination of U.S. tax on income from manufacturing abroad for the U.S. market can make it more advantageous for U.S. firms to manufacture in a low tax environment overseas than in the United States.

Arguments against the proposal

1. In many cases, foreign-made goods will enter the U.S. market not because of tax factors but because of comparative economic advantage (such as lower labor costs). The United States lacks tax jurisdiction over foreign-owned producers of foreign goods. To subject U.S. owners of foreign subsidiaries that produce foreign goods to current U.S. tax will sometimes create a competitive disadvantage for those U.S.-controlled foreign corporations and a competitive advantage for purely foreign producers of goods destined for the U.S. market. In some cases, a foreign corporation controlled by U.S. persons will perform some manufacturing abroad, while its U.S. owner

performs subsequent manufacturing or processing with respect to the same goods in the United States. To that extent, the U.S. company is creating U.S. employment despite use of a runaway plant.

2. Administering special rules for income attributable to goods manufactured for the U.S. market could prove difficult.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Tax income from runaway plants currently and impose separate foreign tax credit limitation	0.1	0.2	0.2	0.6

c. Withholding tax on interest paid to foreigners

Present Law

If a foreigner's U.S. source interest income is not effectively connected with a U.S. trade or business, it is exempt from U.S. tax if it (1) qualifies for a general Code exemption, added in 1984, that applies to "portfolio interest," (2) is paid on a bank deposit, (3) constitutes short-term original issue discount, or (4) qualifies for a treaty exemption.

Possible proposal

Congress could impose a low-rate tax on U.S. source interest income paid to foreign investors. That tax could override treaties only in cases of "treaty shopping," that is, use of one country's treaty by persons who are not residents of that country.

Pros and Cons

Arguments for the proposal

1. Like U.S. lenders, foreign lenders enjoy the income and security from investing in the United States and thus should not be exempt from paying U.S. tax on the income received, particularly since taxable U.S. borrowers reduce their U.S. tax by deducting the interest payments.

2. Under current law, U.S. source interest income might not be taxed in any country. In that case, the borrower may deduct interest paid abroad, reducing domestic tax liability, with no offsetting increase in the tax base of any jurisdiction. Ultimately, unrestricted cross-border lending could cause substantial tax base erosion in both the borrowing and lending countries. Treaty-shopping investors are particularly unlikely to pay home country tax on U.S. source interest income. Also, as a result of enforcement difficulties, some tax-free debt might be held by U.S. persons evading U.S. tax.

3. Tax exemption of interest paid to foreigners, instead of increasing foreign investment in the United States, may cause foreigners to invest in U.S. debt instruments rather than other U.S. assets.

4. Imposition of a withholding tax on interest paid to foreigners would tend to reduce worldwide demand for, and the value of, the dollar. A lower value for the dollar could increase U.S. exports, at least temporarily.

Arguments against the proposal

1. Many foreign countries do not tax interest paid to third-country persons, so imposing the tax would place U.S. borrowers at a disadvantage against some foreign borrowers competing for the same dollars. Moreover, imposing the tax would not result in more

equitable tax treatment among lenders because foreign lenders will not pay U.S. tax on U.S. source interest income; they will instead invest elsewhere.

2. Tax exemption of interest paid to foreigners increases the inflow of capital into the United States and thus allows greater domestic investment at lower interest rates. A tax on this interest would be a barrier to international trade in assets, in the nature of a tariff. The United States should prefer foreign investment in the form of debt to other foreign investment, because lenders generally lack control over U.S. assets and activities.

3. Imposition of a withholding tax on interest paid to foreigners could reduce net capital inflows and thus the value of the dollar. A lower value for the dollar could mean higher inflation, at least temporarily, as prices for imports rise.

4. Imposition of a low-rate withholding tax on existing debt would frustrate the legitimate expectations of foreign investors. Imposition of the tax only on new debt or on newly acquired debt would raise little revenue in the short run.

5. Overriding treaties, even in the case of treaty shopping, would break a U.S. commitment and offend our treaty partners.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
5. percent withholding tax on interest paid to foreigners	(1)	0.2	0.3	0.5

[1] Gain of less than $50 million.

d. Deduction for interest paid to exempt entities

Present Law

In theory, U.S. tax law does not distinguish between U.S. corporations on the basis of ownership. That is, a U.S. corporation pays the same U.S. income tax whether its owners are Americans or foreign persons, or whether its owners are taxable or tax exempt persons.

In practice, however, a U.S. corporation that belongs to owners exempt from U.S. tax may deduct tax-free payments to them. For example, a foreign-owned U.S. corporation may be able to reduce its U.S. taxable income by making interest or royalty payments to related foreign persons. The payor can normally deduct those payments from U.S. taxable income. (In 1984, Congress prohibited the accrual of interest deductions on obligations to related foreign parties until actual payment.) A U.S. income tax treaty (with the recipient's home country) may limit or even prohibit U.S. taxation of those payments in the hands of the recipient.

In addition, characterization of payments that are contingent on an increase in value of an asset ("equity kickers") or on profits in excess of a stipulated amount ("net profits interest") as interest allows a foreign person to extract income realized in the United States in the form of deductible interest, which may be free of U.S. tax. By contrast, if the contingent payment is characterized as reflecting equity ownership, some U.S. tax may be collected.

A similar situation can arise in the case of U.S. tax exempt persons. For example, interest received by a U.S. charity from a less-than-80-percent-owned corporation is not unrelated business taxable income. Thus, for example, if two unrelated U.S. charities each own half of a U.S. corporation, the corporation's interest payments to them are not includible in income.

A taxable U.S.-owned U.S. corporation, by contrast, generally cannot pay tax-free interest or royalties to its owners. In these cases, the United States collects one level of tax. Exceptions to this rule do exist, however.

In 1969, Congress instructed the Treasury Department to prescribe regulations to determine whether an interest in a corporation is stock or indebtedness for tax purposes. The Treasury has never issued these regulations in final form. Today, the determination of a corporation's debt-equity ratio takes place on a case-by-case basis.

Possible Proposals

1. The deduction for interest payments to tax exempt owners of U.S. corporations could be limited. One alternative could be to treat some debt issued to these stockholders as stock if that debt is

too great in proportion to equity. For example, some of the deduction for interest paid to a related tax exempt person could be disallowed if the ratio of debt held by these stockholders to their equity exceeds 1 to 1 or some other ratio. Another alternative could be to deny a deduction for all or a portion of interest to the extent it is paid to related persons and is not included in income for U.S. purposes. (A provision similar to this alternative was included in the Senate amendment to H.R. 3838, the Tax Reform Act of 1986.) A third alternative could be to limit the debt-equity level of a U.S. subsidiary to that of its tax exempt owner.

2. Deny interest treatment for payments that are contingent on an increase in the value of an asset or additional profits.

Pros and Cons

Arguments for the proposals

1. Imposing interest limitations for tax exempt-owned U.S. corporations would limit the "stripping" of earnings through deductible interest.

2. Imposing limitations on interest deductibility would reduce the substantial tax incentive that present law provides for treaty-country owners of U.S. corporations to capitalize those corporations with debt rather than equity.

3. Imposing a debt-equity ratio for U.S. corporations owned by tax exempt entities would provide certainty to the often-disputed issue of what constitutes debt and equity.

4. Reducing the deduction for interest to the extent it is not included in income for U.S. purposes would ensure that a deduction allowed against U.S. income will generally result in an inclusion for U.S. tax purposes.

5. Treating contingent payments as payments on equity would ensure some U.S. tax from income realized from equity investments in the United States.

6. Limiting deductions for interest paid to foreign persons would follow the practices that some foreign countries use with respect to U.S.-owned corporations organized in those jurisdictions.

Arguments against the proposals

1. Unless the limitations on debt-financing apply to taxable U.S.-owned U.S. corporations, the limitations might violate U.S. treaties.

2. Limiting debt-financing of foreign-owned U.S. corporations might cause foreign persons who own or who contemplate buying U.S. corporations to seek other investments.

3. The inability of the Treasury Department and the IRS to issue final regulations to distinguish between debt and equity may indicate that a statutory debt-equity ratio is not wise.

4. Even though interest payments to foreign persons may not be taxed by the United States, those payments generally are taxed in the persons' home countries, thus obviating the need, on grounds of equity, for imposition of United States tax.

5. Imposing limitations on the deductibility of interest would frustrate the Treasury Department's efforts in removing similar

limitations imposed by foreign countries on U.S. persons doing business in those countries.

6. Imposing limitations on the deductibility of interest paid only to related persons could result in use of back-to-back loans (for example, a loan by the related person to a third party and a subsequent loan by the third party to the U.S. corporation) to avoid the limitations, thus increasing any administrative concerns associated with the proposal.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
Disallow deduction for interest paid to related tax-exempt entity to the extent total interest expense exceeds half of pre-interest deduction taxable income and deny interest treatment for contingent payments	([1])	0.1	0.1	0.2

[1] Gain of less than $50 million.

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e. Treatment of South African income

Present Law

A credit against U.S. income tax is available for certain foreign taxes paid. The amount of the foreign tax credit may be reduced, however, in certain circumstances. For example, since 1978 a taxpayer that participates in or cooperates with an international boycott is denied a foreign tax credit for taxes paid on income derived within the countries associated with the boycott.

Under provisions enacted in 1986, foreign tax credits also are denied with respect to income attributable to activities of the taxpayer conducted in a foreign country (1) that has been designated by the Secretary of State as a country that repeatedly provides support for acts of international terrorism; (2) with which the United States does not have diplomatic relations, or (3) the government of which the United States does not recognize (with certain exceptions). Countries that currently fall within one or more of these categories are Afghanistan, Albania, Angola, Cambodia, Cuba, Iran, Libya, North Korea, Syria, Vietnam, and South Yemen.

Foreign taxes that are not creditable under the above rules are deductible. Income from activities in any country listed above is subject to a separate foreign tax credit limitation, so that taxes from other countries cannot offset the U.S. tax on that income. In addition, U.S. shareholders of a controlled foreign corporation are taxed currently on the corporation's income attributable to activities conducted in these countries.

In 1986 Congress enacted the Anti-Apartheid Act, imposing certain economic measures on South Africa. These measures include prohibition of certain types of economic relationships with the South African government and certain business activities in South Africa, including a prohibition on new investment in South Africa (other than in a firm owned by black South Africans) by any U.S. national. Pursuant to the Anti-Apartheid Act, the income tax treaty and protocol between the United Sates and South Africa is terminated effective July 1, 1987.

Possible Proposal

Congress could subject South African operations to the same treatment currently given to operations in countries whose governments support terrorism, do not have diplomatic relations with the United States, or are unrecognized by the United States. Thus, taxes on South African operations would not be creditable (but would be deductible), South African income would be subject to separate foreign tax credit limitation treatment to prevent cross-crediting of excess foreign tax credits against the U.S. tax on South African income, and U.S. shareholders of controlled foreign corporations would be subject to current taxation on corporate income derived from South Africa.

Pros and Cons

Arguments for the proposal

1. It is the policy of the United States, as expressed in the Anti-Apartheid Act, to promote political, economic and social change leading to the dismantling of apartheid and the establishment of a nonracial, democratic political system in the Republic of South Africa. Congress has established a policy of encouraging reforms through economic measures, among other means, that are to be adjusted to reflect progress or lack of progress made by the government of South Africa in meeting the goal of nonracial democracy. Denial of tax benefits for South African operations of U.S. enterprises would serve purposes similar to those served by those measures of the Anti-Apartheid Act terminating the South African tax treaty, prohibiting new investment and certain other economic activities in South Africa, and prohibiting certain transactions with the current government of South Africa. These purposes include reducing the ease and desirability of doing business in South Africa, reducing ties of mutual dependence between U.S. interests and South Africa's local pro-apartheid interests, and imposing disabilities on those who would otherwise transact business with the South African government. Were credits to be denied without also imposing current taxation of income, failure to remove both tax benefits simultaneously could vitiate the effects of denying the credits. As is the case with the economic measures in the Anti-Apartheid Act, the proposed tax changes could be adjusted at a later date to reflect the South African government's future progress or lack of progress in dismantling apartheid.

2. Similarly, Congress has seen fit to express disapprobation of government-sponsored international terrorism, and other activities of foreign governments disruptive of international peace and stability, by denying deferral of U.S. tax, and denying credits for foreign tax, on income from activities in those countries. South African adherence to apartheid puts it in the same class as the countries covered by these existing tax provisions.

Arguments against the proposal

1. The presence of U.S.-owned business in South Africa, and the accompanying degree of U.S. influence in that country, may be a positive factor in the day-to-day lives of the victims of apartheid and in the longer-term cause of ending apartheid. The proposal is a broad-based escalation of the economic measures in the Anti-Apartheid Act, which would tend to further impair the conditions under which the majority of South African citizens live and reduce U.S. influence in South Africa. These are punitive measures better reserved for use at a future date (if ever) when it is clear that there are no longer any positive ends to be served by U.S.-owned businesses working within South Africa.

2. Tax policy generally is better served by tax laws that are not devices of nontax policy. This was a dominant theme of the Tax Reform Act of 1986. Congress enacted that law, in part, because

pre-Reform Act tax rules aimed at affecting economic decisions were found to reduce economic efficiency and impair the perceived fairness of the U.S. tax system. The established anti-apartheid foreign policy of the United States is more effectively promoted by nontax measures that can be carefully targeted to changing foreign policy events and do not involve the IRS in foreign policy implementation. Foreign policy concerns may require a more flexible response than can be achieved with tax Code modifications.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
Treat South African income like income from countries that the United States does not recognize	(1)	(1)	(1)	0.1

[1] Gain of less than $50 million.

f. Foreign earned income exclusion

Present Law

A U.S. citizen or resident is generally taxed on his or her worldwide income, with the allowance of a foreign tax credit for foreign taxes paid on the foreign income. However, under present and prior Code section 911, an individual who has his or her tax home in a foreign country and who either is present overseas for 330 days out of 12 consecutive months or is a bona fide resident of a foreign country for an entire taxable year generally can elect to exclude $70,000 of his or her foreign earned income from his gross income for taxable years beginning after 1986. The maximum exclusion was $80,000 in 1986. The exclusion does not apply to earnings of U.S. employees.

In addition to the exclusion, an individual meeting the eligibility requirements generally may also elect to exclude (or deduct, in certain cases) housing costs above a floor amount.

Possible Proposal

Congress could reduce the maximum foreign income exclusion amount.

Pros and Cons

Arguments for the proposal

1. U.S. citizens who live and work abroad obtain an unwarranted tax advantage over those who live and work in America. There should be no incentive for U.S. citizens to work outside the United States.

2. U.S. citizens who live and work abroad should contribute to the deficit reduction effort.

3. With the low U.S. individual tax rates, many U.S. citizens who live and work abroad obtain exemption from U.S. tax through the foreign tax credit thus eliminating the usefulness of the income exclusion.

4. Some U.S. citizens work abroad for manufacturers that import goods into the United States or that compete in foreign markets against U.S. exports. To that extent, they have a negative effect on the U.S. balance of trade. Some other U.S. citizens who work abroad have no effect on the balance of trade.

Arguments against the proposal

1. U.S. exports are greater when U.S. individuals, who are most familiar with U.S.-made products and services, work abroad. Absent a significant tax benefit, it would be more difficult to find Americans to work abroad. Moreover, elimination of the exclusion would result in higher labor costs for U.S. firms operating overseas.

2. Foreign countries, unlike the United States, generally exempt their citizens' foreign earnings.

3. Americans abroad need special tax treatment because they must pay from personal funds for some services normally borne by State or local governments in the United States, such as schooling for dependents.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Reduce foreign income exclusion to $50,000	0.1	0.1	0.1	0.4

13. Insurance and Annuities

a. Life insurance policies; including single premium or investment-oriented policies

Present Law

Tax treatment of policyholders

Treatment of investment income

Life insurance contracts.—Under present law, the investment income ("inside buildup") earned on premiums credited under a life insurance policy generally is not subject to current taxation to the owner of the policy.

The favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract. Under present law, a life insurance contract is eligible for favorable tax treatment to the policyholder if it meets either of two statutory tests: the "cash value accumulation" test, or the "guideline premium/cash value corridor" test. A contract generally meets the cash value accumulation test if the cash surrender value cannot exceed the net single premium that would have to be paid at that time to fund future benefits under the contract. A contract generally meets the guideline premium/cash value corridor test if the premiums paid under the policy do not exceed certain guideline levels, and the death benefit under the policy is not less than a varying statutory percentage of the cash surrender value of the policy. Adjustment rules provide that cash distributions resulting from reductions in benefits in the first 15 years of the policy are subject to tax (up to a ceiling amount).

Under these rules, investment income on a life insurance policy that has too large an investment component is treated as ordinary income received or accrued by the policyholder during the year.

Annuity contracts.—Under present law, the investment income ("inside buildup") earned on premiums credited under an annuity contract held by an individual is not subject to current taxation in the hands of the owner of the contract.

Present law (as amended by the 1986 Act) provides, however, that the income on a deferred annuity contract for any taxable year is treated as ordinary income received or accrued by the contract owner, if the contract is held by a person who is not a natural person (such as a corporation). Certain exceptions are provided for such contracts that are held (1) under qualified plans, (2) as qualified funding assets under structured settlement arrangements, and (3) in certain other circumstances. The requirement of inclusion of income on a deferred annuity contract also does not apply to immediate annuities (generally, those annuities under which the annuity starting date is no more than a year after the purchase of the annuity).

Thus, other than in the case of a deferred annuity held by a non-natural person, tax generally is deferred on the inside buildup under an annuity contract. An immediate annuity offers a deferral of tax to the extent that the premium paid in any year exceeds the premium necessary to provide annuity income during that year. In the case of a deferred annuity contract held by an individual, deferral of tax on the investment income earned on the contract occurs throughout the period prior to the time that all obligations under the contract are satisfied.

Treatment of payments under insurance or annuity contracts

Life insurance policies.—Under a life insurance contract, all death benefits are excluded from income, so that neither the policyholder nor the policyholder's beneficiary is ever taxed on the inside buildup if the proceeds of the policy are paid to the policyholder's beneficiary by reason of the death of the insured.

Distributions from a life insurance contract that are made prior to the death of the insured generally are includible in income, but only to the extent that the amounts distributed exceed the taxpayer's basis in the contract. Distributions are generally treated first as a tax-free recovery of basis, and then as income.

Annuity contracts.—In the case of an annuity contract (whether immediate or deferred), amounts received after the annuity starting date generally are includible in income. However, under such a contract, the individual's investment in the contract is recovered on a pro-rata basis over the individual's life expectancy.

By contrast, distributions under an annuity contract prior to the annuity starting date are treated as currently taxable to the extent of the previously untaxed income on the contract. Thus, income earned on the contract is subject to tax when distributed (or as it is earned, in the case of deferred annuities held by persons other than natural persons, such as corporations).

Borrowing under insurance or annuity contracts

Life insurance policies.—The inside buildup on a life insurance contract generally is not treated as distributed to the policyholder and subject to current taxation if the policyholder borrows under the policy or receives distributions under it, to the extent of the policyholder's basis in the policy, even though the policyholder has current use of the money.

Under present law, as amended by the 1986 Act, interest on amounts borrowed under a life insurance policy for personal expenditures is treated as nondeductible personal interest (subject to a phase-in rule for taxable years beginning in 1987 through 1990). Present law also treats as nondeductible the interest on debt with respect to policies covering the life of an officer, employee or individual financially interested in the taxpayer (to the extent the debt exceeds $50,000 per officer, employee or individual).

Policyholder loans at low or no net interest rates are not specifically subject to the below-market loan rules under present law.

Annuity contracts.—Amounts borrowed from a deferred annuity contract are treated as distributions under the contract and are treated as received first out of income on the contract.

Tax treatment of insurance companies

Under present law, a life insurance company generally is not subject to tax on the inside buildup on a life insurance or annuity contract because of the life insurance company reserve rules. Under these rules, a life insurance company is allowed a deduction for a net increase in life insurance reserves (taking into account both premiums and assumed interest credited to the reserves). Life insurance reserves are defined to include amounts set aside to mature or liquidate future unaccrued claims arising from life insurance, annuity, and noncancellable accident and health insurance contracts that involve, at the time with respect to which the reserve is computed, life, accident, or health contingencies.

The maximum reserve permitted under present law with respect to a contract equals the greater of (1) the net surrender value of the contract or (2) the Federally prescribed tax reserve. The assumed interest rate to be used to discount future obligations in computing the Federally prescribed reserve is the prevailing State assumed interest rate (generally, the highest rate for computing insurance reserves under the state insurance laws of 26 or more states). By contrast, under present law, tax reserves for unpaid losses of property and casualty insurance companies are subject to discounting by applying the applicable Federal rate (AFR) of interest (specifically, the average of the applicable Federal mid-term rates for the most recent 60-month period beginning after July, 1986).

Present law does not treat reserve deductions of insurance companies as an item of tax preference under the corporate alternative minimum tax.

Possible Proposals

Life insurance contracts

1. As proposed by the President in his 1985 tax reform proposal, the inside buildup on newly-issued life insurance policies could be included in the income of the policyholder. Thus, the policyholder would include in income for a taxable year any increase (other than through unrealized appreciation, in the case of variable contracts) during the year in the amount by which the policy's cash value exceeds the policyholder's investment in the contract.

Alternatively, the inclusion in income of the inside buildup on newly-issued life insurance policies could apply only to policies held by persons other than natural persons.

2. The definition of life insurance could be narrowed for newly issued policies to provide that significantly investment-oriented life insurance policies such as single-premium life insurance policies would not be treated as life insurance policies for Federal income tax purposes and, therefore, that investment earnings on the policy would be currently included in the policyholder's income. For example, if the amount of the premium in any year substantially exceeds the amount needed for level premium funding of the death

benefit, or the income earned on the contract is from high-risk or high-return investments, then the contract would not be treated as life insurance.

Alternatively, only the excess investment income could be taxed currently with respect to newly issued policies.

3. Distributions from newly issued life insurance policies prior to the death of the insured could be treated in the same manner as distributions under annuity contracts prior to the annuity starting date (i.e., income first).

Annuity contracts

1. As proposed by the President's tax reform proposal of May 1985, newly issued deferred annuity contracts held by natural persons could be treated the same as such contracts held by persons other than natural persons, so that income on the contract for any year would be treated as ordinary income received or accrued by the policyholder during the year.

2. The amount that a policyholder could invest in a newly issued deferred annuity contract on a tax-favored basis could be subject to a cap, such as $50,000. Inside buildup on amounts invested in excess of $50,000 could be currently taxable to the policyholder.

Borrowing under life insurance contracts

1. New loans under life insurance policies could receive the same treatment as loans under annuity contracts (i.e., could be treated as distributions under the policy prior to the death of the insured).

2. Low or no net interest policyholder loans could be treated as below-market loans and the foregone interest on the loans could be treated as a distribution of income on the contract to the policyholder.

Treatment of insurance company

1. As proposed by the President's tax reform proposal of May 1985, a life insurance company could be prohibited from deducting increases to reserves for newly-issued life insurance or annuity contracts to the extent that the reserve exceeds the cash surrender value of a contract.

2. Life insurance companies could be prohibited from taking deductions for life insurance reserves (but not reserves for losses which have actually occurred) with respect to all newly issued insurance and annuity contracts, and instead could be permitted to deduct amounts only when a death or distribution creates a liability with respect to such contracts.

3. The deduction for life insurance reserves could be treated as an item of tax preference (i.e., not permitted as a deduction) under the corporate alternative minimum tax.

4. If deductions for life insurance reserves are not otherwise limited, the interest rate applicable in determining Federally prescribed tax reserves of life insurance companies could be conformed to the applicable Federal rate (AFR) (similar to the discount rate for other insurance companies).

Pros and Cons

Arguments for the proposals

1. The tax treatment of life insurance companies and their policyholders results in a total exemption from tax of a substantial amount of investment income. This exemption increases the unfairness and inefficiency of the tax system.

2. Life insurance companies have more favorable tax treatment with respect to their liabilities than other financial intermediaries because they can deduct liabilities that have not yet accrued under generally applicable tax accounting principles. Most companies are not allowed reserves for future expenses; even property and casualty insurance companies are not allowed a reserve deduction until a loss actually occurs (e.g., a disability occurs or a fire or theft takes place). Life insurance companies thus have an unfair tax advantage.

3. It is inappropriate to allow life insurance companies a deduction for amounts credited to policyholders until an amount is included in their income, as is the case with other financial intermediaries.

4. The deferral of tax on the inside buildup of life insurance policies primarily benefits higher-income taxpayers who are able to save yet who do not need a tax-motivated incentive to save. Present law thus reduces the progressivity of the income tax.

5. Tax-free inside buildup of life insurance policies and annuities, unlike tax-favored mechanisms for providing retirement benefits, is not subject to restrictions (such as nondiscrimination rules or contribution or income limits). Thus, continued allowance of tax advantages circumvents important rules applicable to qualified plans and IRAs.

6. Whole life insurance policies frequently are surrendered by the policyholder for their cash value or are encumbered by extensive borrowing which reduces death benefits and, therefore, do not serve a possible public policy of providing for dependents in the event of the insured's death. Thus, investment-oriented life insurance policies are inconsistent with Congressional intent to provide that death benefits are funded through tax-favored inside buildup.

7. In the 1986 Act, Congress expressed a policy concern about opportunities for tax sheltering, and restrictions on life insurance and annuities would be consistent with this concern by eliminating an opportunity for some taxpayers to shelter income by investing in single premium life insurance and deferred annuity contracts.

8. Loans from life insurance contracts often are substantively equivalent to a distribution from the contract prior to the death of the insured because loans are frequently not repaid by the policyholder. Thus, if distributions prior to the death of the insured are treated as a return of income first under the contract, then equivalent treatment is appropriate for policy loans.

9. Limiting the life insurance company reserves for any contract to the cash surrender value of the contract would prevent the overstatement of tax reserves. Cash surrender value is an objective measure of the reserve for policyholder claims, while reserves computed for State regulatory purposes are computed using conservative assumptions.

10. Because the interest rates set by State insurance law are not designed to measure income but rather to keep reserves high enough to encourage insurance company solvency, using State rates tends to overstate reserves and hence to understate life insurance company income, giving an unintended tax benefit to life insurance companies.

Arguments against the proposals

1. Encouraging people with disposable income to provide financially for their dependents in the event of death is an important social policy that should be supported by the tax incentive of permitting tax-free inside buildup of life insurance policies and annuities.

2. Treating inside buildup of life insurance policies as currently taxable to the policyholder would effectively raise the cost of providing insurance coverage and would discourage its purchase, possibly raising the government's cost of providing social services generally.

3. The proposal to tax currently inside buildup on life insurance and annuities would tax policyholders on income they have not yet received.

4. The effect of limiting the reserve deduction for a life insurance company is to tax the company on part of the inside buildup allocable to the policyholder. It is unfair to impose greater tax on a life insurance company merely because the inside buildup on a contract is not taxed currently to the policyholder.

5. It is unfair and unwise to deny insurance companies a deduction for reserves they are required to maintain under State law. Moreover, denial of a reserve deduction could lead to pressure to reduce State reserve requirements, which would increase the risk that policyholders will not be able to recover their claims from the company.

6. Whole life insurance and deferred annuity contracts provide a vehicle by which individuals who do not participate in a qualified pension plan may fund adequate amounts of future retirement income and security for their dependents on a tax-favored basis. Many employers do not have adequate pension plans, and it would be unfair to deny these tax advantages to those who cannot obtain them through their employer plans.

7. The perceived unfair tax advantage of life insurance policies and deferred annuities is not generated by excessive investment orientation, but rather is the result of overzealous or unscrupulous advertising by some members of the insurance industry.

8. Treating loans from life insurance contracts as taxable distributions from the contracts ignores the economic reality of the transaction in which the policyholder in fact suffers a detriment if the loan is not repaid.

9. The prevailing State rates are not significantly different from the applicable Federal rate, and thus there is little substantive effect in changing the applicable rate for discounting life insurance reserves.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Life insurance policies; including single premium or investment-oriented policies:				
(1) Tax inside buildup on new life insurance policies	0.1	0.3	0.4	0.7
(2) Modify definition of investment-oriented insurance	0.1	0.1	0.2	0.4
(3) Treat surrenders on life insurance as income	([1])	([1])	0.1	0.1
(4) Tax inside buildup on deferred annuities	([1])	0.1	0.2	0.3
(5) $50,000 cap on tax-favored deferred annuities	([1])	([1])	([1])	0.1
(6) Loans from life insurance policies treated as distributions	0.2	0.3	0.3	0.7
(7) Below market loans	([1])	([1])	0.1	0.1
(8) Deduction for reserves limited to surrender value	([1])	0.1	0.1	0.2
(9) Deny reserve deductions for new life insurance and annuity contracts	0.2	0.3	0.4	0.9
(10) Treat life insurance reserves as preference items for minimum tax	([1])	0.1	0.1	0.2
(11) Require use of AFR for reserve deductions	0.1	0.1	0.1	0.2

[1] Gain of less than $50 million.

b. Life insurance company consolidation

Present Law

Under present law, if one or more life insurance companies file a consolidated return with one or more nonlife insurance companies, a special rule limits the use of certain losses against the income of the life insurance affiliates. The limitation is equal to the lower of (1) 35 percent of the consolidated net operating loss of the nonlife insurance affiliates, or (2) 35 percent of the taxable income of the life insurance company affiliates.

Income from foreign life insurance corporations that are owned by nonlife insurance affiliates is not treated as life insurance affiliate income for purposes of the loss limitation.

Possible Proposal

Income from controlled foreign life insurance corporations could be treated as life insurance affiliate income for purposes of the loss limitation.

Pros and Cons

Arguments for the proposal

1. Present law creates an incentive for a domestic life insurance company to transfer ownership of its foreign life insurance corporations to its domestic nonlife affiliates in order to avoid the limitation on the use of nonlife losses against life insurance company income.

2. Present law may create an incentive to transfer domestic life insurance business to a controlled foreign life insurance corporation to avoid the loss limitation.

Arguments against the proposal

1. A foreign corporation may not enter into a consolidated return with a domestic life insurance corporation so that it is inappropriate to treat the income of a controlled foreign life insurance corporation as income of a life insurance affiliate.

2. Life insurance companies are the only taxpayers that cannot fully consolidate nonlife losses under present law. Extending the loss limitation to income from a controlled foreign life insurance corporation would aggravate the present law discriminatory treatment.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Life insurance company consolidation....	([1])	([1])	([1])	0.1

[1] Gain of less than $50 million.

c. Treatment of nonprofit insurance providers

Present Law

Present law (as amended by the 1986 Act) provides that an organization described in sections 501(c)(3) or (4) of the Code is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance. For this purpose, commercial-type insurance generally is any insurance of a type provided by commercial insurance companies. The 1986 Act did not, however, alter the tax-exempt status of an ordinary health maintenance organization (i.e., any health maintenance organization, tax-exempt under prior law, which is substantially the same as a Federally chartered health maintenance organization), that provides health care to its members predominantly at its own facility through the use of health care professionals and other workers employed by the organization.

Present law also provides special treatment for existing Blue Cross or Blue Shield organizations and other organizations that meet certain requirements and substantially all of whose activities are providing health insurance. Generally, such organizations are treated as stock property and casualty insurance companies. A special deduction is provided to such organizations with respect to their health business equal to 25 percent of the claims and expenses incurred during the taxable year less the adjusted surplus at the beginning of the year. In addition, such organizations are given a fresh start with respect to changes in accounting methods resulting from the change from tax-exempt to taxable status. Further, such organizations are not subject to the treatment of unearned premium reserves generally applicable to property and casualty insurance companies. Finally, the basis of assets of such organizations is equal, for purposes of determining gain or loss, to the amount of the assets' fair market value on the first day of the organization's taxable year beginning after 1986.

Possible Proposals

1. The special deduction for existing Blue Cross/Blue Shield organizations could be repealed.

2. The tax exemption for health maintenance organizations (HMOs) could be repealed.

3. Health maintenance organizations could be given the same treatment as existing Blue Cross and Blue Shield organizations (i.e., they would not be entitled to tax-exempt status, but they would be eligible for the special Blue Cross/Blue Shield deduction).

Pros and Cons

Arguments for the proposals

1. Health maintenance organizations commonly are structured so that their operation is essentially equivalent to providing insurance coverage for medical expenses, and it is unfair to give them more favorable tax treatment than other providers of health insurance coverage.

2. Continuing exempt status for health maintenance organizations gives them an undesirable competitive advantage, not only over taxable insurers providing comparable coverage of medical expenses, but also over taxable health service providers providing similar medical services.

3. The special 25-percent of claims expense deduction for Blue Cross/Blue Shield organizations creates a competitive advantage for the health insurance business of these organizations compared to the health insurance business of other insurance companies.

Arguments against the proposals

1. Health maintenance organizations are service providers as well as insurers, and taxing them on the grounds that they operate in a manner equivalent to insurers is unfair.

2. Taxing health maintenance organizations like insurance companies would in many instances prove administratively cumbersome.

3. Taxing health maintenance organizations, even if they are given special tax advantages, contravenes Congressional policy to promote that form of providing health services or coverage by granting the provider organizations tax-exempt status.

4. Existing Blue Cross/Blue Shield organizations typically provide health insurance coverage to individuals and small groups who might not otherwise be able to purchase such coverage from other insurance companies. A significant increase in the tax liability of such an existing Blue Cross/Blue Shield organization might force the organization to drop this special coverage.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Treatment of nonprofit insurance providers:				
(1) Repeal special deduction for Blue Cross/Blue Shield	[1]	[1]	0.1	0.1
(2) Repeal tax exemption for HMOs	[1]	[1]	0.1	0.1
(3) Allow HMOs to claim Blue Cross/Blue Shield deduction	[1]	[1]	0.1	0.1

[1] Gain of less than $50 million.

d. Treatment of foreign life insurance companies

Present Law

In the case of a foreign life insurance company, present law requires that income effectively connected with the conduct of an insurance business in the United States be increased by an imputed amount to the company, if its surplus held in the United States is insufficient in relation to a percentage of its total insurance liabilities on its United States business. The effect of this imputation rule is to prevent foreign companies from artificially reducing the amount of investment income subject to tax in the United States. Under the imputation rule, if the required United States surplus exceeds the company's actual United States surplus, the company must increase its income by the product of that excess and its current investment yield on assets held in the United States. For purposes of this calculation, a company's surplus held in the United States is the excess of its assets held in this country over its total insurance liabilities on United States business.

Some foreign life insurance companies may have been seeking to avoid the effect of the provision by incurring large, short-term noninsurance liabilities at the end of the year. This practice (e.g., borrowing a large sum for a short period such as a week) could have the effect of increasing assets by the borrowed amount without any corresponding increase in insurance liabilities. In addition, a company may seek to avoid the provision by holding assets in the United States that have a low current investment yield and substantial unrealized appreciation, which has the two-fold effect of increasing United States assets (which, in the case of real property and stock, are valued at market value), and decreasing the current investment yield on those assets.

Possible Proposal

The imputation rule could be clarified to provide that it take into account the excess of a company's United States assets over its total United States liabilities, not just its insurance liabilities, and that unrealized appreciation in the assets is not taken into account. In addition, the investment yield taken into account could be the investment yield on all assets of the entire company, so that the selection of low-yielding assets to hold in the United States would be irrelevant.

Alternatively, the investment yield on United States assets could take into account in determining the amount of any unrealized appreciation in the assets during the year.

Pros and Cons

Arguments for the proposal

1. The proposal eliminates possible loopholes that would make the imputation provision avoidable at will.
2. The proposal cuts back an unintended and unfair competitive advantage that foreign life insurance companies insuring United States risks have over purely domestic companies insuring such risks.

Arguments against the proposal

1. The proposal could discourage foreign life insurance companies from insuring and reinsuring United States risks and, thus, could make life insurance scarcer and more expensive in the United States.
2. The proposal could prompt foreign jurisdictions to take retaliatory measures against United States insurers operating abroad, and, thus, could hurt United States international competitiveness as well as disrupting international insurance and reinsurance markets.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
Treatment of foreign life insurance companies	(1)	(1)	(1)	(1)

[1] Gain of less than $50 million.

e. Minimum tax treatment of mutual life insurance companies

Present Law

Among the preference items taken into account in computing the corporate alternative minimum tax (as amended by the 1986 Act) is the amount determined by comparing the adjusted net book income of the taxpayer with its unadjusted alternative minimum taxable income (the "book income" preference). In general, the book income used in computing the adjusted net book income of a corporate taxpayer is the net income or loss set forth on the taxpayer's applicable financial statement, with certain conforming adjustments. The applicable financial statement is the statement it provides for regulatory or credit purposes, for the purpose of reporting to shareholders or other owners, or for other substantial nontax purposes. In the case of a corporation that has more than one financial statement, rules of priority are provided for the determination of which statement is to be considered as the applicable financial statement for the purpose of determining net book income.

In the case of a mutual insurance company subject to regulation under State insurance laws, the applicable financial statement is likely to be the statement that the company files with the State insurance regulatory authority, as a mutual company does not have shareholders and consequently does not provide a financial statement for shareholders. Stock life insurance companies, on the other hand, generally do report to shareholders, and consequently the applicable financial statement for such companies is likely to be the statement provided to their shareholders.

For tax purposes, but not for financial reporting purposes, mutual companies are required to include in income the differential earnings amount, an amount intended to take account of the deductibility to mutual companies of policyholder dividends. This addition to Federal taxable income is not normally permitted to be included in the amount reported by a mutual insurance company on its applicable financial statement. Thus, generally, under the book income preference, mutual companies are likely to have a smaller difference between book income and alternative minimum taxable income than are stock companies, and consequently are less likely than stock companies to incur tax liability under the corporate alternative minimum tax.

Possible Proposal

An adjustment could be added to the calculation of book income of mutual life insurance companies to include the differential earnings amount in their book income.

Pros and Cons

Argument for the proposal

1. The proposal would eliminate the unfair advantage of mutual life insurance companies over stock life insurance companies under the book income provision, and would prevent the mutual companies from, in effect, enjoying a reduction in the book income preference.

Argument against the proposal

1. The intention of the book income provision is to take into account a corporation's income for financial reporting purposes, without any adjustments; such adjustments are both unnecessary and complex.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
Minimum tax treatment of mutual life companies	([1])	([1])	0.1	0.1

[1] Gain of less than $50 million.

f. Treatment of certain insurance syndicates

Present Law

Present law provides that property and casualty insurance companies (whether stock or mutual) include in income the underwriting income or loss and the investment income or loss, as well as gains and other income items. Premium income of such taxpayers, for example, is included annually in taxable income, and deductions (e.g., for 80 percent of the increase in unearned premiums, and for the discounted amount of loss reserves) are allowed annually in calculating the taxable income.

Pursuant to a closing agreement between the IRS and the members of an insurance organization formed under the laws of the United Kingdom, these members are provided a three-year deferral of underwriting income or loss, consistent with the organization's traditional accounting method.

Possible Proposal

In the case of a person who is a member of an organization formed under the laws of the United Kingdom to write insurance or reinsurance, the deferral currently allowed pursuant to the closing agreement could be prohibited. Income and loss would be calculated annually in accordance with the principles generally applicable to property and casualty insurance companies.

Pros and Cons

Argument for the proposal

1. The proposal would treat all persons engaged in insuring or reinsuring risks equally, instead of giving certain members of insurance syndicates an unfair tax-created competitive advantage.

Argument against the proposal

1. The proposal would abrogate an express agreement entered into to match the tax treatment of members of the insurance syndicates to the economic arrangements; and thereby could provoke retaliatory United Kingdom tax rules that would disrupt international insurance and reinsurance markets and could make insurance scarcer and more expensive in the United States.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Treatment of certain insurance syndicates...	(1)	(1)	(1)	0.1

[1] Gain of less than $50 million.

g. Capitalize agents' commissions

Present Law

Under present law, a life insurance company generally computes its tax liability by using the accrual method of accounting, or (to the extent permitted in regulations) by using a combination of the accrual method with another method (but not the cash method). All computations, however, to the extent not inconsistent with Federal tax accounting rules, are made in a manner consistent with the manner required for accounting on the annual statement approved by the National Association of Insurance Commissioners ("NAIC"). Consistent with the annual statement reporting requirements, life insurance companies generally deduct agents' commissions when paid.

When premiums are initially included in income, the company also deducts an amount for the concomitant increase in reserves, reflecting the liability to pay death benefits under the policies for which the premiums were paid. Net increases in reserves for the year are treated as deductible, and net decreases in reserves are treated as gross income. The deduction for increases in reserves effects a deferral of a portion of the premium income the company receives.

Possible Proposal

Agents' commissions paid by life insurance companies as an expense of earning premium income could be capitalized and amortized over the period that the premium income remains deferred (for example, over the period of coverage under the policy). Alternatively, the amortization period could be a fixed period of years (e.g., 20 years), for ease of administration.

Pros and Cons

Arguments for the proposal

1. Because a portion of a life insurance company's premium income is deferred through the reserve deduction, while agents' commissions associated with obtaining the premium income are currently deducted, there is a mismatching of income and expenses under present law. The proposal would limit this mismatching of income and expenses and, thus, provide a more accurate measure of insurance company income.

2. Reliance on annual statement methods of accounting for tax purposes is inappropriate in this instance, because the annual statement is founded on State insurance regulators' concerns for insurance company solvency, not on accurate measurement of income.

3. Other insurance companies are required to reduce their reserve deductions by a percentage intended to prevent mismatching of deferred premium income and currently deductible premium acquisition expenses. The proposal would make the treatment of agent's commissions for life insurance companies more consistent with the treatment of premium acquisition expenses by other insurance companies.

Arguments against the proposal

1. The proposal would impose an unjustified administrative burden on life insurance companies because it may be difficult to ascertain the period over which premium income is deferred.

2. The proposal contravenes Congressional policy, expressed in the 1984 reorganization of the provisions for life insurance company taxation, to continue reliance on annual statement methods of accounting to the extent they differ from accrual method accounting. The use of the preliminary term method in computing life insurance reserves partially takes into account the mismatching of income and expenses that occurs under present law.

3. Agents' commissions represent a properly accrued liability at the time a premium payment is received; it is inappropriate to adjust for a perceived mismatching of income and deduction by prohibiting the accrual of a properly accrued expense.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Capitalize agents' commissions	0.1	0.2	0.3	0.6

14. Capital Gains

a. Like-kind exchanges

Present Law

An exchange of property, like a sale, generally is a taxable transaction. However, no gain or loss is recognized if property held for productive use in the taxpayer's trade or business, or property held for investment purposes, is exchanged solely for property of a like-kind that also is to be held for productive use in a trade or business or for investment.

In general, any kind of real estate is treated as of like kind with all other real estate. By contrast, different types of personal property (e.g., equipment or vehicles) are not treated as of like kind. Certain types of property, such as inventory, stocks and bonds, and partnership interests, cannot be used as like-kind property.

The like-kind standard contrasts with the standard generally applying for purposes of providing for nonrecognition of gain upon certain involuntary conversions of property (e.g., through destruction, theft, seizure, or condemnation). Other than upon a condemnation of real estate (to which the like-kind standard applies), present law grants nonrecognition to involuntary conversions only if the taxpayer acquires replacement property that is similar or related in service or use to the converted property. This standard is significantly narrower than the like-kind standard. For example, unimproved and improved real estate are not considered similar or related in service or use.

In one case, a court held that an exchange qualified for like-kind treatment even though the property to be exchanged could be designated by the transferor for up to 5 years after the transaction and even though, under the terms of the transaction, the transferor ultimately could have received cash rather than like-kind property. The Deficit Reduction Act of 1984 provided that transactions generally could qualify for nonrecognition treatment only so long as the replacement property was identified within 45 days and transferred within 180 days of the original transfer.

Possible Proposals

1. The list of types of property that cannot be treated as like-kind property for purposes of the nonrecognition rules could be expanded to include real estate.

2. The like-kind standard could be replaced by the standard, generally applying for purposes of nonrecognition on involuntary conversions, whereby the property that is acquired must be "similar or related in service or use" to the property that is transferred.

3. The like-kind exchange nonrecognition provision could be made applicable only to simultaneous transfers.

Pros and Cons

Arguments for the proposals

1. Nonrecognition on like-kind exchanges is justified only when the taxpayer remains in a similar economic position after the exchange. The like-kind standard as applied to real estate is too broad and flexible to ensure that a taxpayer's economic position is not significantly altered by the exchange, giving investors a tax preference in comparison to investors in productive assets such as stocks and equipment.
2. The like-kind standard for comparing the property transferred with the property received should be no broader than the general standard applying for involuntary conversions. Involuntary conversions are not a tool for tax planning, and give rise to stronger equity reasons for not taxing gain than voluntary exchanges.
3. Recognition of gain is appropriate in nonsimultaneous transfers, where the transferor in effect beneficially receives cash and subsequently buys new property.

Arguments against the proposals

1. Exchanges of like-kind property, including real estate, should not give rise to immediate tax liability, since the taxpayer has not received cash or sufficiently changed the form of his investment.
2. Allowing nonrecognition of gain on like-kind exchanges increases the mobility of capital, by permitting taxpayers to exchange appreciated assets without incurring tax liability.
3. Allowing nonsimultaneous transfers to qualify for nonrecogniton treatment makes it easier for taxpayers to avoid recognition of gain, since such transactions create increased flexibility where the transferor cannot immediately locate suitable replacement property, or where the parties have difficulty in transferring title simultaneously.

b. Individual capital gains

Present Law

Under present law, capital gain net income is taxed the same as ordinary income, beginning in 1988.

Possible Proposal

The maximum rate on individual net capital gains could be 15 percent.

Pros and Cons

Argument for the proposal

Reduction of the capital gains rate will promote economic growth and risky investments.

Argument against the proposal

Reduction of the capital gains rate will increase tax complexity and will cause upper-income taxpayers to pay less income tax.

15. Alternative Minimum Tax

Present Law

Under present law, taxpayers are subject to an alternative minimum tax which is payable, in addition to all other tax liabilities, to the extent it exceeds the taxpayer's regular tax. The tax is imposed at a flat rate of 21 percent (20 percent in the case of a corporation) on alternative minimum taxable income in excess of an exemption amount. Alternative minimum taxable income generally is the taxpayer's taxable income, as increased or decreased by certain adjustments and preferences. The foreign tax credit and, to a limited extent in the case of corporations, the investment tax credit are allowed against the minimum tax.

Adjustments and preferences are provided for accelerated depreciation, mining exploration and development costs, certain long-term contracts, pollution control facilities, installment sales, circulation and research and experimental expenditures of individuals, miscellaneous itemized deductions, itemized deductions for State and local taxes, Merchant Marine Capital Construction Funds, special insurance deductions, percentage depletion, excess intangible drilling costs over 65 percent of oil and gas income, incentive stock options, bad debt reserves, tax-exempt interest on certain newly issued private activity bonds, appreciated property charitable deductions, farm losses, and passive losses.

In addition, for 1987 through 1989, one-half of the excess of pre-tax book income of a corporation over other alternative minimum taxable income is a preference. For taxable years beginning after 1989, three-fourths of the excess of adjusted current earnings over other alternative minimum taxable income is a preference.

Possible Proposals

1. The minimum tax rate for individuals could be increased to a rate greater then 21%.

2. The minimum tax rate for corporations could be increased to a rate greater than 20%.

3. Additional preferences could be added to the minimum tax. Such preferences could include inside buildup on life insurance and annuities, tax-exempt interest on additional bonds, all excess intangible drilling costs, excludable fringe benefits, nonforfeitable pension benefits, circulation expenses and research expenditures of corporations, life insurance company reserves, exclusion of income of foreign sales corporations, allocation of research and experimental expenses between U.S. and foreign income, LIFO inventory, excludable interest on loans to ESOPs, excludable gain on sales to ESOPs, and provisions providing for nonrecognition of gain.

4. Unrelated businesses could be prohibited from consolidating or the passive loss rules could be made applicable to all corporations for purposes of the minimum tax.

5. 100 percent of the excess of book income over other alternative minimum taxable income (until 1990) and 100 percent of the excess of adjusted current earnings over other alternative minimum taxable income (after 1989) could be made preferences.

6. The book income preference could be measured by making adjustments for material events in the same year or years for computing book income as for computing alternative minimum taxable income. This adjustment could apply to events occurring in taxable years beginning after 1984.

Pros and Cons

Arguments for the proposals

1. In periods of budget stringency, the minimum amount that each higher income individual and each corporation should pay should be increased.

2. An across-the board rate change (or surtax) would reduce the benefits of tax preferences without the necessity to revisit each preference and decide the relative merits of different preferences.

3. Some persons would feel that the tax system is fairer if the minimum tax were strengthened.

4. Adding new preferences would improve the measurement of economic income.

5. Limiting consolidation could discourage tax-motivated corporate mergers.

Arguments against the proposals

1. The tax preferences which are subject to the minimum tax are allowed for regular tax purposes to accomplish some social or economic purpose. These goals would be undermined by an increase in the minimum tax rate, or an expansion of the preferences.

2. An increase in the rates would cause more taxpayers to be subject to the minimum tax and therefore would add complexity to the law.

3. In the case of the individual minimum tax, an increase in the rate might be viewed as a device for cutting back on the deductibility of State and local taxes.

4. Adding new preferences, or limiting consolidation among lines of businesses, could cause substantial additional complexity in some cases.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Increase individual rate to 25 percent........	0.8	3.7	2.7	7.1
Increase corporate rate to 21 percent.................	0.3	0.5	0.5	1.3
Add more preferences (including certain fringe benefits, inside buildup on life insurance, nonforfeitable pension benefits)..........	0.1	0.5	0.3	0.9

16. Natural Resources

a. Oil and gas working interests

Present Law

Present law, as amended by the 1986 Act, provides that deductions from passive trade or business activities, to the extent they exceed income from all such passive activities (exclusive of portfolio income), generally may not be deducted against other income. Suspended losses are carried forward and treated as deductions from passive activities in the next year. Suspended losses are allowed in full when the taxpayer disposes of his entire interest in the activity to an unrelated party in a transaction in which all realized gain or loss is recognized. The provision applies to individuals, estates, trusts, and personal service corporations. A special rule limits the use of passive activity losses and credits against portfolio income in the case of closely held corporations.

An activity generally is treated as passive if the taxpayer does not materially participate in it. A taxpayer is treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is regular, continuous, and substantial.

Under present law, a working interest in an oil or gas property is not treated as a passive activity, whether or not the taxpayer materially participates. A working interest for purposes of this provision means an interest with respect to an oil or gas property that is burdened with the cost of development and operation of the property and with respect to which the taxpayer's form of ownership does not limit the liability of the taxpayer.

Possible Proposal

The rule applicable to oil and gas working interests could be repealed. Thus, a working interest in an oil or gas property with respect to which the taxpayer does not materially participate would be treated as a passive activity.

Pros and Cons

Arguments for the proposal

1. All activities in which the taxpayer does not materially participate should be treated the same, and losses from such activities should be subject to the loss limitations enacted in 1986.

2. The passive loss exception favors the oil and gas industry relative to other sectors of the economy. This may cause an inefficient allocation of resources.

Arguments against the proposal

1. Granting tax benefits to investors in oil and gas working interests that are not owned through an entity limiting liability is consistent with national energy security policy.

2. It is difficult for oil and gas drillers to raise capital through the debt market or bank loans due to the volatility of oil and gas prices. The working interest exception encourages needed equity capital to flow into the industry.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Oil and gas working interests	0.1	0.3	0.3	0.7

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b. Percentage depletion

Present Law

Under present law, persons owning economic interests in mines, oil and gas wells, other natural deposits, and timber may deduct an allowance for depletion in computing taxable income. For most natural resources other than timber, taxpayers must use the greater of either percentage or cost depletion.

Under cost depletion, the taxpayer deducts his basis in the property over the life of the mineral resource. The percentage depletion allowance is calculated as a fixed, statutory percentage of the taxpayer's gross income from the mineral property (but not in excess of 50 percent of taxable income from the property). The statutory percentage varies from 5 to 22 percent of gross income, depending upon the mineral.

The allowance for cost depletion may not result in recovery of more than the taxpayer's basis in the property. On the other hand, the percentage depletion allowance is computed without regard to the taxpayer's basis in the property and may, therefore, exceed the taxpayer's cost basis in the property. (In the case of corporations, the percentage depletion deduction for coal and iron ore is reduced by 20 percent of the deduction otherwise allowable in excess of the corporation's adjusted basis in the property.)

In the case of oil and gas wells, the allowance for percentage depletion is computed only with respect to up to 1000 barrels a day of oil or gas production by independent producers or royalty owners. The percentage depletion rate for independent producers and royalty owners is 15 percent. Persons who are retailers or refiners are excluded from independent producer status and are, therefore, not allowed percentage depletion with respect to oil and gas production. Percentage depletion on all oil and gas wells is limited to 65 percent of the taxpayer's taxable income.

Percentage depletion in excess of adjusted basis is an item of tax preference for purposes of the alternative minimum tax.

Possible Proposals

1. The Treasury Department's 1984 tax reform study proposed repealing percentage depletion with respect to the production of all minerals.

2. The President's 1985 Tax Reform Proposal proposed repealing percentage depletion for all minerals except for oil and gas stripper wells owned by independent producers.

Pros and Cons

Arguments for the proposals

1. Percentage depletion allows depletion deductions in excess of cost depletion and in excess of the property's adjusted basis and therefore improperly measures economic income.
2. Percentage depletion subsidizes production in the industries covered by that allowance, and thereby favors investment in those industries.
3. Because percentage depletion subsidizes domestic production, it encourages higher consumption of scarce domestic minerals.

Arguments against the proposals

1. Some mineral industries are currently in a depressed condition. Repeal of pecentage depletion would further reduce their return on investment.
2. Repeal of percentage depletion could cause some marginal wells and mines to be closed in cases where the operator otherwise would have made repairs or other investments to continue production. Once a well or mine is closed, reopening may not be economically justified unless the price of the resource rises much higher than previous levels.
3. Natural resources industries require high-risk investments which should be encouraged by the tax system for reasons of national security.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
Repeal percentage depletion on:				
Oil and natural gas: all wells	0.3	0.5	0.5	1.4
Oil and natural gas: all wells other than stripper wells owned by independent producers	0.2	0.4	0.4	1.0
Other minerals	0.3	0.6	0.6	1.5

c. Intangible drilling costs

Present Law

Under present law, an operator who pays or incurs intangible drilling or development costs ("IDCs") in the development of a domestic oil or gas property or certain geothermal wells, may elect either to expense or capitalize such amounts. For this purpose, IDCs include all expenditures by an operator for wages, fuel, repairs, hauling, etc., in connection with the excavating, grading, drilling, shooting, or cleaning of wells, and all other expenses incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas (or geothermal energy). Generally, IDCs do not include expenses for items which have a salvage value (such as pipes and casings), or items which are part of the acquisition price of an interest in the property.

Generally, if IDCs are not expensed, but are capitalized, they can be recovered through depletion or depreciation, as appropriate. However, if IDCs are capitalized and are paid or incurred with respect to a nonproductive well ("dry-hole"), they may be deducted, at the election of the operator, as an ordinary loss in the taxable year in which the dry hole is completed. In the case of an integrated oil company, 30 percent of the IDCs on productive wells must be capitalized and amortized over a 60-month period.

IDCs in excess of the amount which would have been currently deductible if IDCs had been capitalized and recovered over a 10-year period are an item of tax preference for purposes of the alternative minimum tax, to the extent that this difference exceeds 65 percent of net oil and gas income.

Possible Proposals

1. The Treasury Department's 1984 tax reform study proposed to repeal the election to expense IDCs. Recovery of such expenses would have been required to be made through depletion or depreciation deductions.

2. A repeal of the election to expense IDCs could apply only to integrated oil companies.

3. The IDC expensing election could be repealed and replaced by a requirement that IDCs be capitalized and amortized over some statutory period (e.g., 5 or 10 years).

Pros and Cons

Arguments for the proposals

1. The election to expense IDCs is a departure from general income tax principles which require that costs associated with the production of inventory-type property be capitalized.

2. Expensing of IDCs favors investment in the oil and gas industry relative to other sectors of the economy. This may cause an inefficient allocation of capital.

Arguments against the proposals

1. Expenditures for research and development are expensed under present law. Exploratory drilling is similar to research due to the high level of risk. This may justify comparable treatment.

2. Most new oil wells are drilled by independent drillers who depend upon this deduction to maintain their cash flow. Drilling activity has declined precipitously over the past 18 months. If the expensing option is removed, the number of wells drilled will be further reduced.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Repeal election to expense intangible drilling costs for:				
(1) All producers	1.0	1.6	1.4	3.9
(2) Integrated producers	0.5	0.9	0.8	2.2

17. Compliance

a. Estimated taxes

Present Law

Under present law, individuals owing income tax who do not make estimated tax payments are generally subject to a penalty. In order to avoid the penalty, individuals must make quarterly estimated tax payments that equal at least the lesser of 100 percent of last year's tax liability or 90 percent of the current year's tax liability. Amounts withheld from wages are considered to be estimated tax payments.

The Tax Reform Act of 1986 increased to 90 percent (from 80 percent) the proportion of the current year's tax liability that taxpayers must make as estimated tax payments in order to avoid the estimated tax penalty. This increase became effective with respect to taxable years beginning after December 31, 1986.

Possible Proposals

1. The increase in the proportion of the current year's tax liability that taxpayers must make as estimated tax payments could be delayed for one year.

2. The safe harbor of 100 percent of the previous year's liability could be made inapplicable to sizeable increases in income.

Pros and Cons

Arguments for the proposals

1. The current year (1987) is the first year that taxpayers are subject to most of the provisions in the Tax Reform Act of 1986. Also, many taxpayers were confused by the initial Form W-4 issued by the IRS. Delaying the increase in the estimated tax threshold could be beneficial to taxpayers uncertain of their ultimate tax liability due to these events.

2. Taxpayers who know that their current year's income has increased substantially over that of the past year should not be allowed to utilize the estimated tax payment structure as a mechanism for tax deferral.

Arguments against the proposals

1. The proposal to delay the increase in the estimated tax threshold does not raise additional revenue new to the Federal Government; it shifts revenue from FY 1987 into FY 1988.

2. Taxpayers need the certainty provided by a mechanical estimated tax safe harbor; altering the 100 percent safe harbor would eliminate certainty from that test.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
(1) Delay increase in estimated tax threshold	1.4			1.4
(2) Modify previous year safe harbor (estimated tax)	0.3	0.1	0.1	0.5

b. IRS funding

Present Law

Increasing IRS funding in a number of areas could have a direct impact on Federal revenues. For example, increasing the number of employees in Examination and Collection can increase Federal revenues, so long as the increases are not greater than the ability of the IRS to train and absorb the new employees and so long as the point where increased receipts from greater compliance equal the increase in expenditures relating to the new employees has not been reached.

Increasing IRS funding in other areas may have an indirect (and unmeasurable) impact on Federal revenues. For example, improving and expanding taxpayer assistance and upgrading the IRS telephone and mail response system to taxpayers' inquiries could significantly, albeit indirectly, improve overall levels of taxpayer compliance with the income tax laws.

Possible Proposal

1. It would be possible to increase the level of IRS funding in a number of specific areas. The increases could be targeted to improving taxpayer compliance.

Pros and Cons

Arguments for the proposal

1. Increasing taxpayer compliance can increase Federal revenues without increasing tax rates or otherwise altering substantive provisions of the tax law.

Arguments against the proposal

1. Increases in IRS funding may not be within the jurisdiction of the Committee on Ways and Means.

c. Withholding

Present Law

Under present law, wages and many pension payments are subject to income tax withholding. Most other payments are not generally subject to withholding.

Possible Proposals

1. Withholding could be imposed on income from stocks, bonds, and royalties.
2. Withholding could be imposed on payments to independent contractors, parallel to withholding on wages paid to employees.

Pros and Cons

Arguments for the proposals

1. Withholding increases compliance with the tax laws.
2. The level of tax compliance by independent contractors is one of the lowest rates of all sectors of the economy.
3. There is no tax policy justification for making some forms of income subject to withholding and other forms of income not subject to withholding.
4. It is difficult to distinguish the employment status of many independent contractors from that of employees.

Arguments against the proposals

1. Withholding imposes a substantial administrative burden on those required to do the withholding.
2. Withholding on payments to independent contractors would apply to the gross payments to the independent contractors, and therefore would not necessarily approximate ultimate tax liability, which depends on net income after expenses.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
(1) 10-percent withholding on stocks and bonds	1.9	0.3	0.3	2.5
(2) 10-percent withholding on independent contractors	0.6	0.6	0.7	2.0

d. Collection of debts owed to Federal agencies

Present Law

Federal agencies can notify IRS that a person owes a past due, legally-enforceable debt to the Federal agency. The IRS then must reduce the amount of any tax refund due the person by the amount of the debt and pay that amount to the agency. This program expires on January 1, 1988. Under IRS regulations, the program only affects refunds due individuals, not corporations. Also, the program applies to debts owed to a limited number of Federal agencies.

Possible Proposals

1. Extend the program for two years, either for only those agencies currently participating or for all Federal agencies.
2. Expand the program to cover corporate, as well as individual, debts owed to Federal agencies.

Pros and Cons

Arguments for the proposals

1. The Federal Government should use every means available to collect debts owed to it. The refund offset program provides a mechanism to collect debts owed to Federal agencies that the agencies have been unable to collect themselves.

Arguments against the proposals

1. Taxpayers' confidence in the tax system may be eroded when the tax system is used for non-tax purposes.
2. The compliance level of taxpayers whose refunds are offset may decrease in years following the offset, which would decrease Federal revenues.
3. These proposals could distract the IRS from its primary goal, which is administering and enforcing the Federal tax laws.
4. Many of these debts could be collected by better enforcement and collection activities by the agencies actually owed the money.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Extend debt collection	0.1	(1)	(1)	0.2

[1] Gain of less than $50 million.

e. Escheat of refunds

Present Law

No provision of the Code requires that unclaimed Federal tax refunds escheat (revert) to the Federal Government. Some State courts have held that unclaimed Federal tax refunds escheat to the State.

Possible Proposal

The Code could be amended to require that unclaimed Federal tax refunds escheat to the Federal Government.

Pros and Cons

Arguments for the proposal

1. Because the refunds relate to Federal tax obligations, they are more related to the Federal Government than to the States.

Arguments against the proposals

1. Escheat has generally been utilized by the States, rather than the Federal Government.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
Escheat of refunds	([1])	([1])	([1])	([1])

[1] Gain of less than $50 million.

E. Gift, Estate, and Generation-Skipping Transfer Taxes

1. Rates and Unified Credit

Present Law

A gift tax is imposed on transfers by gift during life and an estate tax is imposed on transfers at death. The gift and estate taxes are a unified transfer tax system in that one progressive tax is imposed on the cumulative transfers during the lifetime and at death.

For 1987, the gift and estate tax rates begin at 18 percent on the first $10,000 of transfers and reach 55 percent on transfers over $3 million. For transfers after 1987, the top gift and estate tax rate is scheduled to decline to 50 percent for transfers over $2.5 million.[1]

In addition, the cumulative amount of any gift or estate taxes is reduced by a unified credit. The gift or estate tax is first computed without any exemption and then the unified credit is subtracted to determine the amount of gift or estate tax payable before the allowance of other credits. The present amount of the credit is $192,800.[2] The unified credit of $192,800 effectively exempts the first $600,000 of transfers from gift and estate tax.

In addition, a generation-skipping transfer tax is imposed on transfers from one generation to another that otherwise would not be subject to a gift or estate tax. The generation-skipping transfer tax has a flat rate equal to the highest gift and estate tax rate. Each transferor of a generation-skipping arrangement is allowed a $1 million exemption.

Possible Proposals

Gift and estate tax rates

1. Retain the gift and estate tax rates applicable in 1987 for transfers made after 1987.

2. Increase the maximum gift and estate tax rates for some higher level (e.g., 65 percent on transfers in excess of $10 million).

3. Provide a single flat rate for the gift and estate tax, e.g., 50 percent if the maximum rate of present law is retained. The Task Force on Transfer Tax Restructuring of the Section of Taxation of

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[1] Prior to the Tax Reform Act of 1976, the top estate tax was 77 percent on transfers over $10 million. The 1976 Act reduced the top gift and estate tax rate to 70 percent on transfers over $5 million. The Economic Recovery Tax Act of 1981 reduced the maximum gift and estate tax rate over a four year period to 50 percent for transfers after 1984. The Deficit Reduction Act of 1984 postponed the reduction in the top gift and estate tax rate from 55 percent to 50 percent for three years (i.e., until transfers made after 1987).

[2] Prior to the 1976 Act, there was a $30,000 lifetime exemption for gift tax purposes and a $60,000 exemption for estate tax purposes. The 1976 Act converted the prior gift and estate tax exemptions into a unified credit that increased from $30,000 to $47,000 over the period 1977 to 1981. The 1981 Act increased the unified credit from $47,000 in 1981 to $192,800 over the period 1981 to 1986.

the American Bar Association has recommended a single flat rate for gift and estate taxes.

4. Impose a 2-percent estate tax on the assets less liabilities held at death with no unified credit allowed.

Unified credit

1. Reduce the amount of the unified credit. For example, the unified credit could be set at its 1982 level (i.e., $62,800 or an exemption equivalent of $225,000) and indexed for subsequent inflation.

2. Phase-out the unified credit for large transfers (e.g., transfers in excess of $10 million).

Pros and Cons

Arguments for the proposals

Transfer tax rates

1. The scheduled reductions in the maximum Federal gift and estate tax rates were enacted in 1981 pursuant to a broad tax reduction measure. They are inappropriate in a time of budgetary restraint.

2. Increasing the maximum gift and estate tax rates (or retaining present gift and estate tax rates) will raise taxes only for the wealthy. The gift and estate taxes are necessary to an overall progressive rate system and increasing the maximum rate of gift and estate taxes insures a progressive tax structure.

3. With the present level of the unified credit, the gift and estate tax rates effectively begin with a rate of 37 percent on transfers in excess of $600,000 and reach a maximum rate of 55 percent on transfers in excess of $3 million (50 percent on transfers in excess of $2.5 million after 1987). Thus, the gift and estate tax rates are nearly flat. Nonetheless, much estate planning arises from attempts to utilize fully the lower rate brackets for estates of both spouses.

Unified credit

The increase in the unified credit enacted in 1981 was intended to offset the effects of inflation on property values. Since the rate of inflation has been significantly lower than anticipated, much of this increase has proved unnecessary. Lowering the unified credit to the 1982 level (adjusted for inflation) would still leave the great majority of estates exempt from Federal estate tax.

Arguments against the proposals

Transfer tax rates

1. Retention of the scheduled reduction in the maximum rate of gift and estate taxes is consistent with the general reduction in income tax rates.

2. A higher maximum estate tax rate creates hardship because cash needs are typically high at death.

Unified credit

1. Reduction of the unified credit will subject many more estates to Federal estate tax. Since real estate and closely-held businesses

often appreciate more than other assets, the estates of many homeowners and owners of closely held businesses would be subject to estate tax.

2. Death is an inopportune time to impose a tax, because needs for cash are typically high at that time. Thus, the estate tax should not apply to small and mid-sized estates (i.e., those with assets valued at $600,000 or less), which are most likely to have an acute need for cash.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Rates and unified credits:				
a. 2% death tax with no credit....	(1)	0.8	1.0	1.8
b. Freeze 1987 rates......................	(1)	0.2	0.2	0.5
c. 60% top rate above $10 million	(1)	0.1	0.2	0.3

[1] Gain of less than $50 million.

2. Repeal of the "Stepped-up Basis" Rule

Present Law

The cost or basis of property acquired from or passing from a decedent is its fair market value at the date of death (or alternate valuation date if that date is elected for estate tax purposes). The basis of property acquired from or passing from the decedent is often referred to as a "stepped-up basis." Under the stepped-up basis rule, appreciation after the decedent acquired the property is not subject to income tax.

On the other hand, in the case of property acquired by gift, the donee's basis generally is the same as the donor's. The basis of property acquired by gift is often referred to as a "carryover basis."

The Tax Reform Act of 1986 repealed the tax favored treatment of capital gains.

Possible Proposals

1. An income tax could be imposed on the net appreciation in property passing from a decedent at his death. In order to exempt relatively small estates from such an appreciation tax, that tax could be offset by an exemption or any unused portion of the decedent's unified credit. Property passing to a surviving spouse or to charity would not be subject to the appreciation tax, but would receive a carryover basis similar to that provided for transfers by gift. As under present law, the basis of all other property would be its fair market value at the date of death. A similar proposal was described in the report of the Task Force on Transfer Tax Restructuring of the Section of Taxation of the American Bar Association.

2. Alternatively, it would be possible to achieve a similar result by permitting a partial credit against the estate tax for the decedent's basis in the property includible in the gross estate. In order to raise revenue, the enactment of the credit would be coupled with increased estate tax rates.

3. The basis of an asset acquired from a decedent could be made equal to the decedent's basis in the asset (i.e., a carryover basis).

Pros and Cons

Argument for the proposals

1. Adoption of any of the proposals would end the "lock-in" effect of present law under which taxpayers retain assets during their lifetimes in order to obtain forgiveness of the tax on the gain at death through the "stepped-up" basis rule. This "lock-in" effect has been exacerbated by the 1986 Act changes. The "lock-in" effect impedes the efficient operation of the capital markets.

2. Under these proposals, the overall taxes imposed on property would be roughly the same regardless of whether the property is

sold before death by the decedent, sold after death by his estate or heir, or sold by a donee to whom the property had been given prior to death.

3. Under the Canadian income tax, both death and gift are treated as realization events—a system which generally is viewed as workable.

Arguments against the proposals

1. In order to comply with the rule taxing appreciation at death (or carryover basis), individuals would be required to retain written records for all their assets. Many taxpayers do not keep such records. The Congress should not impose such an extensive recordkeeping burden on the public.

2. Even where individuals keep adequate records of the bases of their assets, the executor or spouse must locate those records. Moreover, where decedent does not keep such records and the are not otherwise available, executors and heirs will have difficulty complying with an appreciation tax.

3. Any tax on appreciation of assets held at death (or a carryover basis for such assets) would increase the overall taxes on assets passing from one generation to another.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Repeal of "stepped up" basis rule:				
Capital gains at death	(1)	4.9	5.3	10.2
Carryover basis	(1)	0.5	1.2	1.7

[1] Gain of less than $50 million.

3. Taxation of Life Insurance

Present Law

The proceeds of a life insurance policy on the decedent's life are includible in the gross estate of the decedent if either (1) the proceeds are receivable by the executor or administrator or payable to the estate or (2) the decedent at his death (or any time within three years of his death) possessed any "incidents of ownership" in the policy. Incidents of ownership include the power to change the beneficiary of the policy, to assign the policy, to borrow against its cash surrender value, and to surrender or cancel it.

Possible Proposal

Include in the gross estate the proceeds of any insurance policy payable, directly or indirectly, to a relative of the decedent. A similar proposal was described in the report of the Task Force on Transfer Tax Restructuring of the Section of Taxation of the American Bar Association.

Pros and Cons

Arguments for the proposal

1. Under present law, an individual may take out a life insurance policy, irrevocably designate beneficiaries of the policy, and transfer all incidents of ownership to another person. In that situation, the proceeds of the life insurance policy are not includible in the decedent's gross estate even if the decedent pays all policy premiums. Such an arrangement effectively transfers property at death while avoiding estate tax.

2. Life insurance is inherently a death-time transfer. Adoption of the proposal would ensure that all transfers at death are subject to estate tax. The requirement that the proceeds be paid directly or indirectly to a relative of the decedent ensures that the proposal would not result in estate taxes being imposed upon "key man" insurance purchased by the individual's employer or partners.

Arguments against the proposal

1. Life insurance often has a significant investment element which should be taxed like other investments. Consequently, life insurance should be includible in the gross estate only where the decedent retained interest in, or control over, the investment at his death.

2. The transfer of the incidents of ownership and the payment of insurance premiums are subject to the gift tax and, consequently, the present tax treatment of life insurance does not permit improper avoidance of transfer taxes.

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Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Life insurance inclusion	([1])	0.3	0.4	0.7

[1] Gain of less than $50 million.

4. Valuation of Property: Estate Freezes and Minority Discounts

Present Law

In general

The value of property includible in a gross estate is its fair market value at the date of the decedent's death (or on the alternate valuation date if the executor so elects). The fair market value is 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 to sell and both having reasonable knowledge of relevant facts.

Where actual sales prices and bona fide bid and asked prices are lacking, the fair market value of stock is determined by looking to various factors, including the company's net worth, prospective earning power and dividend-paying capacity, the goodwill of the business, the economic outlook in the particular industry, the company's position in the industry and its management, the degree of control of the business represented by the block of stock to be valued, and the values of securities of corporations engaged in the same or similar lines of businesses.

Valuation freezing techniques

Where an individual transfers a remainder interest in property but retains the income from that property for his life, his gross estate includes the full value of the property. An individual may, however, exclude from his gross estate the value of common stock transferred to others, even though he retains preferred stock in that corporation with the right to most dividends. *See Estate of John G. Boykin*, 53 T.C.M. (CCH) 345 (1987). A person also may exclude from her estate the value of an option to purchase property owned by her, despite her enjoyment of the property prior to the exercise of the option. *See Dorn v. United States*, 59 A.F.T.R. 2d ¶ 148,875 (W.D. Pa. 1986).

Estate planners use the above rules to "freeze" the value of property so that appreciation in the estate's assets accrues to the owners' children and is thereby excluded from the gift and estate tax base. One method is to recapitalize a closely-held corporation to have both voting preferred and common stock outstanding. The par value of the preferred stock is set at the estimated value of the corporation at that time. The owners give the common stock to their children and retain the preferred stock themselves. The owners claim that since the par value of the preferred stock is set at the estimated value of the corporation, the common stock has little value and, consequently, there is little or no gift tax owed. At the owners' death the executor values the preferred stock at its par value (i.e., the value of the preferred stock is "frozen" at the time of the recapitalization). Appreciation in the value of common stock accrues to the children and passes between generations without being subject to gift or estate taxes.

Another technique for freezing the value of property is for the owner to grant to his children a long-term option to purchase the property at its current value. Since the option price is the present value of the underlying property, the value of the option is claimed to be very low. Nonetheless, the option is said to limit the value of the property to the option price, allowing the appreciation to avoid estate taxation.

A third method is for an individual to give a spouse an income interest in a trust, plus a general power of appointment over a specified dollar amount. Under the marital deduction, no gift tax is imposed on the gift to the spouse, and the spouse would include only the specified amount in her estate. Thus, any appreciation in the value of the trust will apparently be taxed in neither spouse's estate. *See* Estate of *Alexander* v. *Commissioner,* 82 T.C. 34 (1984), aff'd No. 84-1600 (4th Cir. April 3, 1985).

Minority discounts

Numerous courts recognize that shares of stock in a corporation which represent a minority interest are usually worth less than a proportionate share of the value of the assets of the corporation. See, e.g., *Charles W. Ward*, 87 T.C. 78 (1986); *Estate of Leyman*, 40 T.C. 100 (1963). More recently, a minority discount was allowed even where the total shares owned by related persons constituted a majority interest. For example, in *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981), the court upheld a minority discount on stock transferred to a trust even though the other principal shareholder of the corporation was trustee of the trust and father of its beneficiary.

Possible Proposals

Estate freezes

The parent's estate could include the full value of property which is effectively subject to the retained life interest (i.e., the common stock as well as the preferred stock, in the recapitalization case, and the value of property as of the date of death, in the option case). A life estate with a power of appointment could be deemed as not passing to the spouse for purpose of the marital deduction unless the spouse's power is expressed as a fraction or a percentage of the estate.

Minority discounts

The value of property for Federal gift, estate, and generation-skipping transfer tax purposes could be determined by aggregating other interests in the property owned by related individuals. Alternatively, the value of stock in closely-held corporations could be deemed to be a proportionate share of the corporation's value, for those purposes.

Pros and Cons

Arguments for the proposals

1. With the recapitalization technique described above, the parent effectively retains a life interest in the corporation by keeping the voting preferred stock. Similarly, the option technique permits the parent effectively to retain a life estate and transfer a remainder interest to the children. The estate tax result should not differ simply because the economic benefit of the property is reserved through preferred stock or non-exercise of the option rather than a retained life estate.

2. A minority discount is proper only where the owners have adverse interests. Related persons generally share the same interests.

Arguments against the proposals

1. Preferred stock and property owned subject to an option provide rights significantly different from those of a retained life estate. Any abuse of estate freezing techniques lies not in the retained estate, but in the undervaluation of the gift (of common stock or option).

2. Family members do not always share the same interests and, in those situations, disallowing a minority discount results in overvaluation of property for gift, estate, and generation-skipping transfer tax purposes.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Valuation of property:				
a. Estate freeze	([1])	0.6	0.8	1.4
b. Minority discount	([1])	0.5	0.5	1.1

[1] Gain of less than $50 million.

5. State Death Tax Credit

Present Law

A 100-percent credit is allowed against the Federal estate tax for any estate, inheritance, legacy, or succession taxes paid to a State. The maximum credit varies with the size of the adjusted taxable estate. The maximum credit begins at .8 of 1 percent for assets less than $90,000 and increases to 16 percent on assets in excess of $10,040,000.

Possible Proposal

The credit for State death taxes could be converted into a deduction.

Pros and Cons

Arguments for the proposal

1. State death taxes should be treated no more advantageously than State income taxes are treated under the Federal income tax.
2. The existing State death tax credit is a form of revenue sharing. Many States only impose death taxes that are entirely creditable against the Federal estate tax. States should not be able to collect taxes whose burden is to be borne by the Federal Government rather than their citizens.

Arguments against the proposal

1. The State death tax credit has been in the estate tax law for over 50 years.
2. Converting the credit into a deduction would pressure States to repeal or reduce their death taxes, reducing State revenues.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Change State tax credit to deduction......	([1])	0.4	0.5	0.9

[1] Gain of less than $50 million.

6. Definition of Present Interest for Purposes of the Annual Gift Tax Exclusion

Present Law

Under present law, the first $10,000 of gifts of present interest are excluded from Federal gift tax. Several courts have held that a donee's power to withdraw annual additions to the trust during the year in question gave that donee a present interest in the additions. See, e.g., *D. Clifford Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968). This result has been upheld even where the donee is a minor or lacks knowledge of his right of withdrawal.

Possible Proposal

Require that the power of withdrawal last until the death of the donee in order to characterize an interest as a present interest.

Pros and Cons

Arguments for the proposal

1. One reason for limiting the annual gift tax exclusion to gifts of present interests is to insure that the donee obtains sufficient control over the interest so that the gift does not inure to another person. A power of withdrawal that is effective for only a very short duration does not insure that the gift will not be given to another beneficiary of the trust.
2. Use of a short-term power of withdrawal is an important means of utilizing the $10,000-per-donee annual gift tax exclusion to avoid gift or estate taxes.

Argument against the proposal

The limitation of the annual gift tax exclusion to present interests was designed to prevent remainder interests in property from qualifying for the exclusion. A short-term power of withdrawal does not give the donor a remainder interest and can serve legitimate estate planning purposes.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
Present interest (gift tax exclusion).........	(1)	(1)	(1)	0.1

[1] Gain of less than $50 million.

7. Estate Tax Deduction for Sales to an Employee Stock Ownership Plan (ESOP) or Worker-Owned Cooperative

Present Law

The 1986 Act adopted a special provision allowing partial relief from estate taxes through an estate tax deduction for certain sales of employer securities to an employee stock ownership plan (ESOP) or eligible worker-owned cooperative. Under this special provision, the value of the taxable estate of a decedent is determined by deducting from the value of the gross estate 50 percent of the qualified proceeds of a qualified sale of employer securities. A qualified sale is any sale of employer securities by an executor to an ESOP or an eligible worker cooperative. Qualified proceeds is the amount received by the estate from the sale of employer securities at any time before the due date of the estate tax return, but does not include proceeds from sales of securities received by the decedent (1) in distribution from a qualified plan or (2) as a transfer pursuant to certain options or rights to acquire stock.

IRS Notice 87-13 (January 5, 1987) provided that the estate tax deduction is not available unless (1) the decedent directly owned the employer securities immediately before death, and (2) after the sale, the employer securities are allocated to plan participants or are held for future allocation in connection with a transfer of assets from a defined benefit plan or with an exempt loan.

The deduction is not available for sales of employer securities after December 31, 1991.

Possible Proposals

1. H.R. 1311 and S. 591 could be adopted. The bills confirm the positions taken in IRS Notice 87-13 and further modify the scope of the estate tax deduction for sales of stock to an ESOP.

Under the bills, the availability of the deduction would be partially curtailed. The maximum allowable deduction would be limited to 50 percent of the taxable estate and the maximum reduction in tax liability would be limited to $750,000. Proceeds attributable to transferred assets would not be taken into account. The deduction would be limited to proceeds of sales of qualified employer securities (1) that are issued by a domestic corporation which has no stock outstanding which is readily tradable on an established securities market, (2) which are includible in the gross estate of the decedent, and (3) which would have been includible in the gross estate of the decedent if the decedent had died within a specified prior period. Certain holding period requirements would apply. An excise tax would be imposed if an ESOP or eligible worker-owned cooperative disposes of employer securities within three years of acquisition or fails to allocate the securities or the proceeds of the disposition to accounts of participants or their beneficiaries.

2. The deduction could be repealed in its entirety.

Pros and Cons

Arguments for the proposals

1. The bills (H.R. 1311 and S. 591) limit the total revenue loss from the special estate tax deduction to the amount originally estimated and conform the provision to original Congressional intent.

2. The existence of special tax benefits for transfers of stock to an ESOP creates an incentive to maintain an ESOP as a primary source of retirement income for employees. The tax laws should not create an incentive for an employer to maintain one type of retirement plan to the exclusion of other types. If an employer experiences financial difficulty, employees with retirement savings concentrated primarily in employer stock may be subject to a double risk of loss. Not only would employees lose their jobs (and employer contributions to their retirement plan possibly would be reduced or eliminated), but they also may suffer from decreases in the value of the securities and the amount of dividends paid thereon. Moreover, if a plan is permitted to invest substantially in employer securities, a plan fiduciary could be subject to great pressure to time purchases and sales to improve the market in those securities, whether or not the interests of plan participants were adversely affected.

Arguments against the proposals

1. Making frequent changes in the ESOP area creates uncertainty and thereby discourages the use of ESOPs.

2. The tax incentives historically afforded ESOPs represent an attempt to balance tax policy goals encouraging employee stock ownership with those encouraging employer-provided retirement benefits. The special tax benefits for ESOPs are designed to encourage the sales of stock to ESOPs by shareholders with whom the stock ownership has been concentrated, thereby expanding the individuals having an ownership interest in an employer. The estate tax deduction for sales of securities to an ESOP accomplishes this goal of expanded capital ownership by creating an incentive to transfer stock ownership from a decedent's family to the employees of the employer whose stock the decedent held.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
Modify estate tax deduction for ESOPs ..	1.8	1.5	2.1	5.4

F. Tax-Exempt Organizations

1. Unrelated Business Income Tax on Certain Trade Association Income

Present Law

The Code imposes a tax on the unrelated business income of otherwise tax-exempt organizations (secs. 511-514). Although this tax generally applies only when an exempt organization receives income from an unrelated trade or business, special rules apply to certain types of organizations.

In the case of social clubs (sec. 501(c)(7)), voluntary employee's beneficiary associations (sec. 501(c)(9)), and supplemental unemployment benefit trusts or group legal service organizations (secs. 501(c)(17), (c)(20)), the unrelated business income tax (UBIT) applies to all income of the organization other than exempt function income (sec. 512(a)(3)). The latter category of income (exempt function income) that is not subject to the UBIT consists of (1) income from dues, fees, charges, or similar amounts paid by the organization's members in connection with its exempt purposes; (2) certain investment income (or certain other types of income) set aside to be used for charitable purposes, or for purposes of paying life, sick, accident, or other benefits in the case of section 501(c)(9), 501(c)(17), or 501(c)(20) organizations; and (3) gain on certain dispositions of assets used by the organization in performing its exempt purposes.

Under this rule, investment income and other nonexempt function income earned by social clubs and the specified mutual benefit organizations are subject to the UBIT. The legislative history of this rule reflects that since such entities are granted exempt status so that their members may join together to provide social facilities or other personal benefits without tax consequences, the Congress concluded that the tax exemption should be limited to membership receipts. If investment income could be earned tax-free, the members of such entities would receive personal benefits out of tax-free funds.

Under present law, trade associations and similar organizations described in section 501(c)(6) generally are not subject to tax on interest, dividends, royalties, or certain rents, gains on recognition disposition of assets, or other types of income that generally are excluded from the UBIT (unless derived from debt-financed property or from certain controlled organizations). Thus, trade associations receive more favorable treatment of investment income than social clubs or certain other mutual benefit organizations.

Possible Proposal

The unrelated business income of trade associations could be computed in a manner similar to that applicable under present law to social clubs and certain other mutual benefit organizations. Thus, any investment income and other nonexempt function income of trade associations would become subject to the UBIT. As under present law, the UBIT would not apply to dues, fees, charges, and similar amounts received from members in connection with the association's exempt functions; certain investment or other income set aside for charitable purposes; or gain on certain dispositions of assets used in performing exempt purposes.

Pros and Cons

Arguments for the proposal

1. Exempting the investment income of a trade association from the UBIT allows the organization's members to obtain an immediate deduction for dues or similar payments to the organization in excess of amounts needed for current operations, but to avoid tax on a proportionate share of earnings from investing the surplus amounts. If the member had retained the surplus and invested that amount itself, the earnings thereon would be taxed in the year earned to the member. While investment income earned tax-free by the organization may be used to lower member payments (and hence member deductions) in later years, the member still has gained a benefit through tax deferral.

2. The broad exemption provided for investment income and certain other nonexempt function income of charitable organizations (sec. 501(c)(3)) can be justified on the ground that such organizations lessen the burdens of government that otherwise would have to be financed through tax revenues, and serve a broad class of beneficiaries within the public at large, rather than simply members of or donors to the organizations. By contrast, tax-exempt trade associations generally operate to provide facilities, goods, or services that benefit their members.

A trade association can be viewed as a conduit or agency-type entity, since the organization operates on behalf of its members to promote the line of business to which they belong. To the extent the organization receives member payments for purposes such as advertising the goods in that line of business, exemption from UBIT for member payments may be justified even if exceeding expenditures within the organization's taxable year. However, this rationale does not extend to investment or nonexempt function income of the organization.

Arguments against the proposal

1. It can be argued that the analogy of trade associations to social clubs is not persuasive. The very purpose of a social club is to provide private benefits of a recreational or social nature to its members; accordingly, Federal tax benefits for such organizations are limited for the reasons cited above. On the other hand, a trade association is entitled to exempt status only if its activities are aimed at improving the business conditions generally of a line of business, as distinguished from the performance of particular services for individual members of the organization. Thus, it can be argued that the special UBIT rules for social clubs (or certain other

mutual benefit organizations) are not appropriate for trade associations.

2. If the members of the trade association had carried on directly the activities of their association, they generally would have been entitled to deductions for such expenditures; by contrast, personal expenditures for social or recreational activities at a country club are not deductible. Hence, it is not appropriate to extend the tax treatment of social club investment income to trade associations.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988-90
Unrelated business income tax (certain trade association income	([1])	([1])	0.1	0.1

[1] Gain of less than $50 million.

2. Excise Tax on Net Investment Income of Exempt Organizations

Present Law

Under present law (sec. 4940), private foundations generally are subject to a two-percent excise tax on their net investment income. This tax was imposed so that foundations would share some of the costs of government, particularly the cost of administering the tax laws relating to exempt organizations. While the section 4940 tax sometimes is referred to as an "audit fee," the tax receipts go into the general fund and are not earmarked for IRS use relating to foundations or other exempt organizations. Further, although the tax rate has been reduced since its enactment in 1969, the tax revenues for fiscal 1986 exceeded the total IRS costs of administering the combined exempt organization and employee plan programs.

All tax-exempt organizations, including charitable and social welfare organizations, mutual benefit organizations, and pension trusts (sec. 401(a)), generally are subject to tax on any unrelated business taxable income. However, a specific statutory modification to the unrelated business income tax provides that the tax does not apply to dividends, interest, royalties, and certain other types of investment income, except where derived from debt-financed property or certain controlled organizations.

Possible Proposal

An excise tax of five percent could be imposed on the net investment income of all tax-exempt organizations, i.e., on the sum of gross investment income (including interest and dividends) plus net capital gain, less the expenses of earning such income. This excise tax would apply to all corporations or trusts that are tax-exempt from Federal income tax under section 501(a), including charitable, educational, religious, and scientific organizations; social welfare organizations; labor unions; trade associations; social clubs; other mutual benefit organizations; and trusts forming part of a qualified pension or profit-sharing plan (described in sec. 401(a)).

Pros and Cons

Arguments in favor of the proposal

1. In times of large Federal budget deficits, all organizations that benefit from the expenditures of the Federal Government should be called upon to contribute to reducing the budget deficits. Organizations that are exempt from Federal income tax benefit from direct Federal spending—for example, for national defense, maintenance of the banking system, aid to interstate transportation, etc.—as well as from Federal tax expenditures, such as exemption from income tax and, in some cases, the itemized deduction for charitable contributions. Accordingly, like other institutions in the econo-

my, these tax-exempt organizations should not be immune from sharing some of the costs of government through a modest excise tax on investment income.

2. The proposed excise tax would not apply to noninvestment income of such organizations, such as dues paid to membership organizations for their exempt purposes, charitable contributions, or related business income (e.g., tuition paid to schools or patient fees paid to hospitals). Accordingly, the proposed excise tax would have a limited impact on the activities of exempt organizations.

3. The proposed excise tax could be "sunsetted" so that it would not apply once the budget deficit is reduced to a specified level.

Arguments against the proposal

1. Investment income of most tax-exempt organizations has been exempt from income or other Federal taxation since the inception of the tax statute, except in limited situations (such as debt-financed income or the excise tax applicable only to certain private foundations). This exemption reflects a recognition that many exempt organizations perform functions that lessen the burdens of government that otherwise would have to be financed out of tax revenues, promote the general welfare of the public at large, or contribute to the economic well-being of the country through promotion of business and labor.

2. The imposition of the tax would reduce the funds available to and needed by charities, social welfare organizations, and other exempt organizations in carrying out their nonprofit activities. The tax thus would adversely affect the beneficiaries of these programs, including the poor, the elderly, students, hospital patients, the environment, etc.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
Excise tax of 5% on investment income of exempt organizations	3.5	5.5	6.0	15.1

3. Unrelated business income tax—equity kickers on loans to business ventures

Present Law

A tax-exempt organization must pay tax at regular income tax rates on its unrelated business taxable income ("UBTI"). If a tax-exempt organization makes an equity investment as a partner in a partnership, the income it receives attributable to the business activities of the partnership is UBTI. However, certain passive investment income, such as interest or dividends, generally is excluded from the definition of UBTI.

Due to the UBTI exception for passive investment income, if a tax-exempt organization makes a loan to a partnership, the interest it receives on the loan generally is not UBTI. However, it is frequently difficult to distinguish a debt investment from an equity investment. Court cases and revenue rulings indicate that a loan made with a significant "equity kicker" can still be debt, and no portion of the amounts received are other than interest, even though the return on the equity kicker depends upon the entrepreneurial success of the venture. Even a return based on net profits may be considered interest on debt that is not UBTI, although economically it may be virtually identical to a preferred equity interest in the partnership.

In other contexts in the Code, a return based on net profits is not considered sufficiently passive to qualify for certain tax benefits that are available only if the recipient does not engage in significant active, business-type operations. For example, such a return generally would not constitute qualified income of a real estate investment trust (REIT). If such nonqualified income exceeds specified limits, the REIT no longer is treated as a passive conduit, but is subject to entity level taxation. A return based on gross receipts generally would be qualified income of a REIT even though in effect such amounts might produce a return based on net profits in certain circumstances.

Possible Proposal

The income of a tax-exempt organization from a partnership investment involving an equity kicker could be treated as an equity investment that may produce unrelated business taxable income. This rule could be limited to cases where the return on the investment is based on net profits of the venture.

Pros and Cons

Arguments for the proposal

1. Tax-exempt entities should not be able to receive amounts based on an increase in the equity value of a venture without

paying the same unrelated business income tax they would pay on an investment designated as equity.

2. Tax-exempt entities should be subject to at least the same standards of passivity, with respect to the income that may be received free of tax, as apply in determining whether a real estate investment trust is taxed at the entity level.

Arguments against the proposal

1. Tax-exempt entities should be permitted to maximize the amounts that they may receive free of tax, to enhance the funds available for their tax-exempt purposes.

2. Tax-exempt entities should not be held to a stricter standard distinguishing debt from equity than other investors.

Revenue Effect

[Fiscal years, billions of dollars]

Proposal	1988	1989	1990	1988–90
Unrelated business income tax—equity kickers on certain loans	([1])	([1])	([1])	([1])

[1] Gain of less than $50 million.

III. ESTIMATED REVENUE EFFECTS OF POSSIBLE OPTIONS TO INCREASE REVENUES, FISCAL YEARS 1988–90

[Billions of dollars]

Item	1988	1989	1990	1988–90
I. Revenue Areas Addressed by President's 1988 Budget Proposals				
A. Employment Tax Provisions				
1. Extend Medicare payroll tax to all State-local employees	1.3	1.9	1.9	5.2
2. Expand employer share of FICA tax to include all cash tips	0.2	0.3	0.3	0.8
3. Extend FICA tax to inactive duty earnings of military reservists and certain other earnings	0.2	0.3	0.3	0.7
4. Treatment of group-term life insurance as wages under FICA	([1])	0.1	0.1	0.2
5. Railroad retirement tax				
a. Increase in railroad retirement payroll tax	0.1	0.2	0.3	0.6
b. Partial rail sector financing of vested dual benefits	0.1	0.1	0.1	0.2
c. Extend FUTA tax to railroad employment	0.1	0.1	0.1	0.4
B. Excise Tax Provisions				
1. Proposals relating to black lung benefits				
a. Increase in coal excise tax	0.3	0.3	0.3	0.8
b. Inclusion of black lung cash benefits in gross income	0.1	0.2	0.2	0.5
2. Repeal of current gasohol, bus, and State-local government highway excise tax exemptions	0.2	0.3	0.3	0.8
3. Airport and Airway Trust Fund excise taxes				
a. Extend present excise taxes	([2])	([2])	([2])	([2])
b. Increase air ticket tax to 10 percent, etc	0.6	0.7	0.7	1.9
4. Imposition of air and ship travel tax	([1])	([1])	([1])	0.1
5. Repeal of windfall profit tax	([3])	([3])	([3])	([3])
C. PBGC Premiums (negative outlay)	0.3	0.3	0.2	0.8

Footnotes at end of tables.

III. ESTIMATED REVENUE EFFECTS OF POSSIBLE OPTIONS TO INCREASE REVENUES, FISCAL YEARS 1988–90—Continued

[Billions of dollars]

Item	1988	1989	1990	1988–90
D. Certain New User Fees				
1. Internal Revenue Service	0.1	0.1	0.1	0.2
2. Bureau of Alcohol, Tobacco and Firearms	0.1	0.1	0.1	0.2
3. Customs Service:				
a. President's proposal	0.1	0.2	0.6	0.9
b. Freeze fee at 0.22 percent and repeal schedule 8 exemption	0.3	0.3	0.8	1.4
c. Repeal schedule 8 exemption	0.1	0.2	[1]	0.3
4. Coast Guard	0.4	0.5	0.5	1.3
II. Other Possible Revenue Options				
A. Excise Taxes				
1. Alcoholic beverage taxes				
a. Double taxes on all alcoholic beverages:				
(1) Distilled spirits	2.1	2.3	2.3	6.8
(2) Beer	1.1	1.2	1.2	3.5
(3) Wine	0.3	0.3	0.3	1.0
b. Index alcoholic beverages taxes after doubling:				
(1) Distilled spirits		0.1	0.1	0.2
(2) Beer		[1]	0.1	0.1
(3) Wine		[1]	0.1	0.1
c. Increase tax rates to present distilled spirits rate:				
(1) Beer	3.3	3.4	3.4	10.1
(2) Wine	1.7	1.8	0.9	5.5

d. Double distilled spirits tax rate and increase wine and beer tax rates to increased distilled spirits rate:				
(1) Distilled spirits	2.1	2.3	2.3	6.8
(2) Beer	7.2	7.4	7.5	22.1
(3) Wine	3.5	3.6	3.9	11.0
e. Increase wine tax rate to present beer tax rate	0.4	0.4	0.4	1.1
f. Double beer tax rate and increase wine tax rate to increased beer rate:				
(1) Beer	1.1	1.2	1.2	3.5
(2) Wine	0.8	0.9	0.9	2.6
g. Increase alcohol taxes by 50 percent:				
(1) Distilled spirits	1.2	1.2	1.2	3.7
(2) Beer	0.6	0.6	0.6	1.8
(3) Wine	0.2	0.2	0.2	0.5
h. Repeal reduced distilled spirits tax on alcohol derived from wine	[1]	[1]	[1]	0.1
2. Tobacco products taxes				
a. Double present tobacco excise tax rates	3.0	3.1	3.1	9.2
b. Index tobacco products tax at doubled rates	3.0	3.3	3.5	9.8
c. Double present tobacco excise tax rates and extend to pipe tobacco	3.1	3.1	3.1	9.3
d. Increase present tobacco excise rates by 50 percent	1.6	1.6	1.6	4.8
e. Triple present tobacco excise tax rates	5.7	5.8	5.8	17.3
3. Telephone tax				
a. Extend present excise tax for 3 years	1.3	2.3	2.5	6.0
b. Extend present tax for 3 years with 5-percent tax for mobile telephone usage	1.3	2.3	2.5	6.1
c. Increase excise tax to 4 percent and extend for 3 years	1.7	3.0	3.3	9.4
d. Phase-out present tax after 1-year extension (at 0.5 percent/year)	1.3	2.0	1.8	5.1
e. Impose 10-percent excise tax on telephone equipment sold to persons other than common carriers	0.4	0.6	0.7	1.7

III. ESTIMATED REVENUE EFFECTS OF POSSIBLE OPTIONS TO INCREASE REVENUES, FISCAL YEARS 1988-90—Continued

[Billions of dollars]

Item	1988	1989	1990	1988-90
4. Luxury taxes				
a. 10-percent tax on value of autos in excess of $20,000	0.3	0.4	0.4	1.2
b. 10-percent tax on value of boats, yachts in excess of $10,000	0.1	0.1	0.1	0.3
c. 10-percent tax on general aviation aircraft	0.2	0.3	0.3	0.8
d. 10-percent tax on value of furs	0.1	0.1	0.1	0.2
e. 10-percent tax on value of consumer electronic entertainment products (including TVs, radios, stereo equipment, VCRs, video cameras, and related products)	1.5	2.8	3.0	7.3
f. 10-percent tax on value of jewelry and precious gemstones in excess of $100	0.2	0.4	0.4	1.1
5. Firearms (double rates of present excise taxes on firearms)	0.1	0.1	0.1	0.3
6. Pollution taxes				
a. Sulfur and nitrogen emissions tax of 45 cents per pound ($1 per pound of CFC-11 or equivalent in 1988, $2 in 1989, and $3 in 1990)	6.4	6.9	5.7	19.0
b. Tax on ozone-depleting chemicals	0.3	0.5	0.7	1.6
7. Energy taxes				
a. Broad-based energy tax:				
(1) $0.20 per thousand Btu	9.8	10.3	10.5	30.6
(2) 5 percent of value	12.2	13.8	14.6	40.6
b. Broad-based petroleum tax:				
(1) $1.25-per-barrel tax on all oil consumption	5.0	5.2	5.2	15.4
(2) $2.50-per-barrel tax on all oil consumption	10.0	10.1	10.1	30.1
(3) $5-per-barrel tax on all oil consumption	19.6	19.1	18.9	57.6

c. Oil import tax:				
(1) $4-per-barrel tax, no exemptions	6.5	5.9	5.9	18.3
(2) $5-per-barrel tax, no exemptions	8.0	7.0	6.9	21.9
(3) $5-per-barrel tax on imported crude oil, $7.50-per-barrel tax on imported refined petroleum products	8.6	7.2	7.0	22.8
(4) Tax equal to the excess of $24 over the weighted-average price of imported crude oil on all imported crude and refined petroleum products; exemption for petroleum products used in agriculture, home heating oil, and in the manufacture of products for export	12.1	5.7	4.9	22.7
(5) Tax equal to the excess of $24 over the weighted-average price of imported crude oil on all imported crude and refined petroleum products	15.7	9.7	8.7	34.1
(6) $5-per-barrel tax on imported and domestic oil; credit equal to excess of $20 over the world price of oil for domestic production, limited to $5	8.0	7.0	7.0	21.9
8. Motor fuels taxes				
a. Increase by 5 cents per gallon	4.7	4.5	4.5	13.7
b. Increase by 10 cents per gallon	9.3	9.0	8.8	27.1
c. Increase by 10 cents per gallon, plus index	9.3	9.7	10.3	29.4
d. Increase gasoline tax by 5 cents per gallon	4.0	3.8	3.8	11.6
e. Increase gasoline tax by 10 cents per gallon	7.9	7.5	7.4	22.8
f. Increase by 5 cents per gallon; extend to all fuels covered by LUST tax	5.0	4.9	4.8	14.7
g. Increase by 10 cents per gallon; extend to all fuels covered by LUST tax	10.0	9.6	9.4	28.9
h. Collect gasoline tax at refinery gate	0.3	(1)	(1)	0.3
i. Collect diesel fuel and special motor fuels tax on sale to retailer	0.1	0.1	0.1	0.4
j. Repeal alcohol fuels tax exemption and credit	0.2	0.2	0.2	0.7
9. Gas guzzler tax				
a. Double tax	0.1	0.1	0.1	0.2
b. Increase mileage limits			(1)	(1)

III. ESTIMATED REVENUE EFFECTS OF POSSIBLE OPTIONS TO INCREASE REVENUES, FISCAL YEARS 1988–90—Continued

[Billions of dollars]

Item	1988	1989	1990	1988–90
10. Increase Trust Fund taxes by an amount to compensate for—				
a. Implicit income tax offsets	4.4	4.7	4.9	14.0
b. Implicit income tax offsets plus revenue loss from tax-exempt bond financing	9.2	9.8	10.1	29.0
11. FUTA tax				
a. Index FUTA wage base to increases in average national earnings (effective 1989)		0.2	0.6	0.8
b. Extend FUTA repayment tax for 3 years	0.7	1.0	1.0	2.7
B. General Consumption Taxes				
1. 5-percent VAT	69.5	100.7	103.4	273.6
2. 5-percent VAT with exceptions for food, housing, and medical care	40.2	58.3	59.8	158.3
3. 7-percent BAMT [4]	27.8	41.2	43.9	112.9
C. Securities Transfer Excise Tax	5.0	7.5	10.0	22.5
D. Income Tax Provisions				
1. Individual and corporate tax rates and surtaxes				
a. 5-percent individual surtax	10.3	20.1	22.6	53.0
b. 5-percent corporate surtax	3.6	6.3	7.0	16.9
c. 5-percent individual surtax on tax over $10,000	3.1	6.2	7.4	16.7
d. 5-percent corporate surtax on tax over $10,000	3.3	5.9	6.4	15.7
e. Freeze 1987 rate schedule:				
(1) One year (individual)	9.0	7.4		16.4
(2) One year (corporate)	8.2	5.5		13.7
(3) Permanent freeze with indexing (individual)	9.0	18.8	23.0	50.9

f. Impose 33-percent rate on income levels above phaseout of personal exemptions	2.8	6.5	8.8	18.2
g. 38.5-percent top rate above $225,000 of income (for joint returns), with 33-percent intermediate rate; 28-percent gains rate	4.7	9.9	12.3	26.9
2. Across-the-board reduction in individual tax preferences (10 percent for itemized deductions; 20 percent for certain credits and preferences)	1.2	11.4	11.8	24.4
3. Individual income tax provisions				
a. Credit for child and dependent care expenses:				
(1) Phaseout for AGI over $50,000 (ending at $88,000)		0.3	0.4	0.7
(2) Deny credit for overnight camp expenditures	([1])	0.1	0.1	0.1
b. Interest expense deduction on home equity loans:				
(1) Limit to acquisition indebtedness	0.2	1.7	1.8	3.8
(2) $10,000 limit (other than education and medical)	([1])	0.3	0.3	0.6
(3) Nondeductible, if no fixed term	([1])	([1])	([1])	0.1
(4) $1 million cap	([1])	0.3	0.3	0.6
(5) Boats and mobile homes ineligible	([1])	([1])	([1])	([1])
c. Other itemized deductions:				
(1) Disallow nonbusiness personal property tax deduction	0.1	0.4	0.4	0.9
(2) Floor under aggregate itemized deductions equal to 10 percent of AGI over $50,000 ($100,000 for joint returns)	1.0	7.2	8.7	16.9
(3) Limit itemized deductions to 15-percent bracket	3.4	22.7	24.7	50.7
4. Business meals and entertainment expenses				
a. Allow 75-percent deductibility	0.2	0.5	0.6	1.3
b. Allow 50-percent deductibility	1.3	2.4	2.8	6.6
5. Employee benefits/pensions				
a. Employer-provided health insurance: [5]				
(1) Cap exclusion ($840/$2,100 per year)	3.3	6.0	7.5	16.8
(2) Floor on exclusion ($120/$300 per year)	2.8	4.2	4.6	11.6
(3) Cap exclusion for FICA and FUTA only ($840/$2,100 per year)	1.2	2.1	2.6	5.9
(4) Repeal exclusion for FICA and FUTA only	9.1	14.6	16.7	40.4

III. ESTIMATED REVENUE EFFECTS OF POSSIBLE OPTIONS TO INCREASE REVENUES, FISCAL YEARS 1988-90—Continued

[Billions of dollars]

Item	1988	1989	1990	1988-90
b. Employer-provided group term life insurance:				
(1) Repeal exclusion	2.0	3.1	3.2	8.4
(2) Repeal exclusion for FICA and FUTA only	0.8	1.3	1.3	3.4
c. Employer-provided death benefits	(1)	(1)	(1)	0.1
d. Employer-provided dependent care assistance:				
(1) Repeal exclusion	(1)	0.1	0.1	0.2
(2) Repeal exclusion for FICA and FUTA only	(1)	(1)	(1)	0.1
e. Repeal exclusion for employee benefits with respect to high-income employees	1.1	1.8	2.0	4.8
f. Cafeteria plans:				
(1) Cap cash option under a cafeteria plan ($500 per year)	0.8	1.4	1.9	4.1
(2) Repeal cafeteria plan exception for FICA and FUTA only	0.6	1.2	1.7	3.5
(3) Disqualify dependent care assistance from cafeteria plan exception	(1)	0.1	0.1	0.2
g. Meals and lodging furnished for the convenience of employer:				
(1) Restrict exclusion for corporate officers and significant shareholders	(1)	(1)	(1)	(1)
(2) Restrict employer deduction	0.2	0.3	0.3	0.9
h. Pensions				
(1) Treat plan loans as distributions	(1)	0.1	0.1	0.2
(2) Modify full funding limitation (150 percent rule)	0.6	1.8	1.4	3.9
(3) Modify active participant rules	(1)	(1)	(1)	(1)
i. Repeal special ESOP rules	0.1	0.2	0.2	0.5

6. Accounting provisions				
a. Cash accounting denied for large nonfarm business	0.1	0.3	0.3	0.8
b. LIFO inventory accounting:				
(1) Repeal LIFO and amortize income change	2.6	4.6	4.7	11.9
(2) Charge interest on LIFO reserves	1.5	2.6	2.7	6.7
c. Completed contract method:				
(1) Require 100-percent use of percentage of completion method for all long-term contracts (effective 1988)	0.4	1.4	2.2	4.0
(2) Phase-in percentage of completion method (60 percent in 1987, 80 percent in 1988, 100 percent in 1989 and thereafter)	0.8	1.3	1.7	3.8
d. Repeal vacation pay reserve	0.1	0.1	[1]	0.2
e. Advertising costs:				
(1) Overall:				
(a) Require 4-year amortization of 20 percent of advertising costs incurred during taxable year	3.0	4.5	3.3	10.8
(b) Deny deduction for 20 percent of corporate advertising costs and amortize remainder over 2 years for firms with over $5 million of gross receipts	12.7	15.7	9.5	37.9
(2) Deny advertising deduction and promotion expense for:				
(a) Tobacco products	0.5	0.8	0.9	2.2
(b) Alcohol products	0.3	0.5	0.6	1.4
f. Amortization of intangibles	[1]	[1]	[1]	0.1
g. Apply section 265 to holders of installment sale obligations of State and local governments	[1]	0.1	0.1	0.2
h. Below-market loans to certain continuing care facilities	[1]	[1]	[1]	[1]
7. Farming provisions				
a. Cash accounting:				
(1) President's proposal: Repeal for farms with gross receipts over $5 million	0.2	0.3	0.3	0.8
(2) Repeal for farms with gross receipts over $50 million	0.1	0.2	0.2	0.5
(3) Repeal for farms with gross receipts over $100 million	0.1	0.1	0.1	0.3

III. ESTIMATED REVENUE EFFECTS OF POSSIBLE OPTIONS TO INCREASE REVENUES, FISCAL YEARS 1988-90—Continued

[Billions of dollars]

Item	1988	1989	1990	1988-90
b. Treat farm losses like real estate losses under the passive loss rules	0.4	1.2	1.4	3.0
c. Increase cost recovery period for single-purpose agriculture structures to 15 years	(1)	(1)	(1)	(1)
8. Financial institutions				
a. Repeal tax-exempt status of credit unions	0.2	0.4	0.4	1.0
b. Tax treatment of recoveries of bad debts of thrift institutions	(1)	(1)	0.1	0.1
9. Corporate provisions				
a. Intercorporate dividends received deduction changed from 80 percent to 75 percent	0.1	0.2	0.3	0.6
b. Limitations on use of losses of Alaska Native Corporations	(1)	(1)	(1)	0.1
c. Eliminate graduated rates for personal service corporations	0.1	0.1	0.1	0.3
11. Depreciation provisions				
a. Extend recovery period to 125 percent of lease or other contract term	0.1	0.2	0.2	0.4
b. Limitations on depreciation deductions for luxury automobiles	(1)	0.1	0.2	0.3
c. Income forecast method of amortization	(1)	(1)	(1)	(1)
12. Foreign tax provisions				
a. Repeal title passage source rule	0.3	0.7	0.7	1.7
b. Income from runaway plants	0.1	0.2	0.2	0.6
c. 5-percent withholding tax on interest paid to foreigners	(1)	0.2	0.3	0.5
d. Interest paid to exempt entities	(1)	0.1	0.1	0.2
e. Treatment of South African income	(1)	(1)	(1)	0.1
f. Reduce foreign earned income exclusion to $50,000	0.1	0.1	0.1	0.4

13. Insurance and annuities				
a. Life insurance policies; including single premium or investment-oriented policies:				
(1) Tax inside buildup on new life insurance policies	0.1	0.3	0.4	0.7
(2) Modify definition of investment-oriented insurance	0.1	0.1	0.2	0.4
(3) Treat surrenders of life insurance as income	[1]	[1]	0.1	0.1
(4) Tax inside buildup on deferred annuities	[1]	0.1	0.2	0.3
(5) $50,000 cap on tax-favored deferred annuities	[1]	[1]	[1]	0.1
(6) Loans from life insurance policies treated as distributions	0.2	0.3	0.3	0.7
(7) Below market loans	[1]	[1]	0.1	0.1
(8) Deduction for reserves limited to surrender value	[1]	0.1	0.1	0.2
(9) Deny reserve deductions for new life insurance and annuity contracts	0.2	0.3	0.4	0.9
(10) Treat life insurance reserves as preference items for minimum tax	[1]	0.1	0.1	0.2
(11) Require use of AFR for reserve deductions	0.1	0.1	0.1	0.2
b. Life insurance company consolidation	[1]	[1]	[1]	0.1
c. Treatment of nonprofit insurance providers:				
(1) Repeal special deduction for Blue Cross/Blue Shield	[1]	[1]	0.1	0.1
(2) Repeal tax exemption for HMOs	[1]	[1]	0.1	0.1
(3) Tax HMOs like Blue Cross/Blue Shield	[1]	[1]	0.1	0.1
d. Treatment of foreign life insurance companies	[1]	[1]	[1]	[1]
e. Minimum tax treatment of mutual life companies	[1]	[1]	0.1	0.1
f. Treatment of certain insurance syndicates	[1]	[1]	[1]	0.1
g. Capitalize agents' commissions	0.1	0.2	0.3	0.6
14. Capital gains				
15. Alternative minimum tax				
a. Increase rates:				
(1) 25 percent (individual)	0.8	3.7	2.7	7.1
(2) 21 percent (corporate)	0.3	0.5	0.5	1.3
b. Add more preferences (including certain fringe benefits, inside buildup on life insurance, nonforfeitable pension benefits)	0.1	0.5	0.3	0.9

III. ESTIMATED REVENUE EFFECTS OF POSSIBLE OPTIONS TO INCREASE REVENUES, FISCAL YEARS 1988–90—Continued

[Billions of dollars]

Item	1988	1989	1990	1988–90
16. Natural resources				
a. Oil and gas working interests	0.1	0.3	0.3	0.7
b. Repeal percentage depletion for:				
(1) Oil and natural gas—all wells	0.3	0.5	0.5	1.4
(2) Oil and natural gas—all wells other than stripper wells owned by independent producers	0.2	0.4	0.4	1.0
(3) Other minerals	0.3	0.6	0.6	1.5
c. Repeal expensing of intangible drilling costs for:				
(1) All producers	1.0	1.6	1.4	3.9
(2) Integrated producers only	0.5	0.9	0.8	2.2
17. Compliance provisions				
a. Estimated tax:				
(1) Delay increase in estimated tax threshold	1.4	......	......	1.4
(2) Modify previous year 100-percent safe harbor for sizeable increases in income (estimated tax)	0.3	0.1	0.1	0.5
b. Withholding:				
(1) Withholding on stocks and bonds (10-percent rate)	1.9	0.3	0.3	2.5
(2) Withholding in independent contractors (10-percent rate)	0.6	0.6	0.7	2.0
c. Extend debt collection	0.1	(1)	(1)	0.2
d. Escheat of refunds	(1)	(1)	(1)	(1)
E. Gift, Estate and Generation-Skipping Transfer Taxes [6]				
1. Rates and unified credit				
a. 2-percent death tax with no credit	(1)	0.8	1.0	1.8
b. Freeze 1987 rates	(1)	0.2	0.2	0.5

c. 60-percent top rate above $10 million	([1])	0.1	0.2	0.3
2. Repeal of "stepped-up" basis rule:				
a. Capital gains at death	([1])	4.9	5.3	10.2
b. Carryover basis	([1])	0.5	1.2	1.7
3. Life insurance exclusion	([1])	0.3	0.4	0.7
4. Valuation of property				
a. Estate freeze	([1])	0.6	0.8	1.4
b. Minority discount	([1])	0.5	0.5	1.1
5. Change State tax credit to deduction	([1])	0.4	0.5	0.9
6. Present interest (gift tax exclusion)	([1])	([1])	([1])	0.1
7. Modify ESOP provisions	1.8	1.5	2.1	5.4
F. Tax-Exempt Organizations				
1. Unrelated business income tax—certain trade association income	([1])	([1])	0.1	0.1
2. Excise tax of 5 percent on investment income of exempt organizations	3.5	5.5	6.0	15.1
3. Unrelated business income tax—equity kickers on certain loans	([1])	([1])	([1])	([1])

[1] Gain of less than $50 million.

[2] Extension of the Airport and Airway Trust Fund is assumed in the CBO baseline.

[3] Under current oil price projections, no windfall profit tax revenues are expected during this period.

[4] Estimate does not include revenue reduction attributable to possible BAMT credits (for FICA, income tax liability, and NOLs) or to a possible capital gains exclusion, 5-percent investment credit, or repeal of the alternative minimum tax.

[5] Options concerning employee benefits include income tax and FICA effects, unless otherwise noted.

[6] Estimates of E.1–6. assume E.7. is adopted.