[JOINT COMMITTEE PRINT]

SUMMARY OF TAX REFORM OPTION FOR CONSIDERATION BY COMMITTEE ON WAYS AND MEANS

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a brief summary of the tax reform option for consideration by the Committee on Ways and Means, beginning on September 26, 1985.

This document is organized by topics generally as in the columnar spreadsheets document. (See forthcoming document, *Tax Reform Proposals in Connection with Committee on Ways and Means Markup.*) Part I summarizes individual income tax provisions. Part II summarizes provisions relating to the tax treatment of capital income. Part III summarizes corporate tax provisions and ESOPs. Part IV summarizes tax shelter-related provisions. Part V summarizes minimum tax provisions for individuals and corporations. Part VI summarizes foreign-related provisions. Part VII summarizes provisions related to tax-exempt bonds. Part VIII summarizes provisions relating to the taxation of financial institutions. Part IX summarizes accounting-related provisions. Part X summarizes tax provisions related to insurance products and companies. Part XI summarizes pensions and deferred compensation and fringe benefits. Part XII summarizes income taxation of trusts and estates and the generation-skipping transfer tax. Finally, Part XIII summarizes provisions relating to taxpayer compliance and tax administration.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Summary of Tax Reform Option For Consideration by the Committee on Ways and Means* (JCS-43-85), September 26, 1985.

I. Individual Income Tax Provisions

A. Basic Rate Structure

The three rates proposed by the President (15, 25, and 35 per cent) would be retained, although the brackets at which these rate would apply would be adjusted slightly. The zero bracket amoun would be converted to a standard deduction. The standard deduc tion would be phased in, by 1987, to $6,000 for joint returns, $4,27 for heads of househould and $3,550 for unmarried individuals. Th standard deduction would be increased by $500 for each dependen and for elderly and blind taxpayers.

The proposed option would contain a $1,500 personal exemption As under the President's proposal, the tax entry point would b structured to remove individuals below the poverty level from th tax rolls, though the benefit that these adjustments would provid to upper income taxpayers would be reduced.

In a change from the President's proposal, substantial marriag penalties generally would be reduced. Relief would be provide through the rate structure and standard deductions, rather tha through the use of a two-earner deduction as under present law

The President's proposed expansion of the earned income credi generally would be followed, except that the phase-out level woul be raised, thus expanding it somewhat further.

Changes would also be made to the President's proposal regard ing dependent care. First, the present law exclusion for dependen care assistance provided by an employer would be repealed. Second the child care credit would be increased slightly over its presen law levels.

As proposed by the President, income averaging would be re pealed.

Effective date.—These provisions generally would be effective fo taxable years beginning after December 31, 1985.

B. Tax Treatment of the Elderly and Disabled

1. *Personal exemptions.*—The proposed option would provide tha the standard deduction would be increased by $500 for an individ ual over age 65 and by $500 for a blind individual.

2. *Elderly credit.*—The proposed option would retain the presen law credit for the elderly.

3. *Wage replacement benefits.*—The proposed option follows th President's proposal to repeal the exclusion for unemploymen compensation. However, the option would revise the President's proposal with regard to other wage replacement benefits b making workers' compensation, black lung disability, and certai other employer-provided disability benefits partially includible i income to the extent that AGI (not including the disability bene fits) exceeds $15,000 for a single individual, $20,000 for a marrie

:ouple filing a joint return, and zero for a married couple filing ;eparately. The amount includible would equal the lesser of (1) one-ıalf of AGI (not including such benefits) in excess of the base ımount of (2) the amount of such benefits.

?. *Exclusions for Scholarships, Prizes, and Awards*

1. *Scholarships and fellowships.*—The President's proposal would imit the exclusion to amounts spent on tuition and equipment by legree candidates and to incidental expenses of nondegree candi-lates. The proposed option is the same except that no exclusion vould be allowed for nondegree candidates, who could deduct such ımounts if constituting business expenses. The proposed option vould be effective for scholarships and fellowships granted after ;eptember 25, 1985.

2. *Prizes and awards.*—The President's proposal and the pro-›osed option would repeal the exclusions for prizes and awards other than certain scholarships and fellowships, as described ıbove). Under both proposals, awards by employers to employees :ould not be treated as "gifts." The proposed option would clarify :hat de minimis awards to employees would be deductible by the ›mployer but tax-free to the employee.

?. *Deductions for Personal Expenditures*

1. *Deduction for certain State and local taxes.*—The President's ›roposal to repeal the itemized deduction for nonbusiness State and ocal taxes would be revised. While deductions for sales taxes and ›ersonal property taxes (other than those incurred in a business or nvestment activity) would be disallowed, State and local income ınd real property taxes would be deductible in part. For these two :ypes of taxes, individuals would be permitted a deduction equal to :he *greater* of $1,000 ($500 for unmarried taxpayers) or the portion ın excess of five percent of the individual's adjusted gross income.

This provision would be effective for taxable years beginning ıfter December 31, 1985.

2. *Charitable deduction for nonitemizers.*—As under the Presi-lent's proposal, the proposed option would repeal the nonitemizer :haritable deduction for contributions made after 1985, i.e., one year earlier than the scheduled termination of the nonitemizer de-luction under present law.

3. *Itemized deduction for adoption expenses.*—The proposed option is the same as the President's proposal. The itemized deduc-tion allowed for certain expenses of adopting handicapped or other special-needs children would be repealed; at the same time, the ex-isting adoption assistance spending program would be expanded to cover the types of expenses now allowed to itemizers.

E. *Business and Investment Expenses*

1. *Travel and entertainment expenses.*—Under the proposed option, 75 percent of business meal expenses and 50 percent of en-tertainment expenses would be deductible. The President's propos-al would limit meal deductions to $25 times the number of partici-pants in the meal, plus one-half of the excess, and would complete-ly disallow deductions for most entertainment expenses.

The proposed option would disallow deductions for costs of at tending conventions relating to investments, rather than to th taxpayer's business. Also, the option would place limitations on de ductions for travel expenses while attending other conventions, fo business trips on cruise ships and certain travel claimed to be edu cational or charitable.

2. *Employee expenses and miscellaneous itemized deductions.*– The proposed option would place a one-percent floor under th itemized deduction for miscellaneous employee and investment ex penses, and would include in that category certain employee busi ness travel and other expenses that are currently also deductibl by nonitemizers. The President's proposal would also impose a one percent floor under these types of expenses, but would allow th excess to be deductible "above-the-line." Also, the proposed optio would tighten present-law rules for deducting home office expense and hobby losses.

F. Political Contributions Tax Credit

The proposed option is the same as the President's proposal; i.e. the income tax credit for a limited amount of political contribu tions would be repealed after 1985.

G. Presidential Campaign Checkoff

The proposed option would retain the $1 checkoff on the individ ual tax return for the Presidential Election Campaign Fund; th President's proposal would repeal the checkoff.

II. Capital Income

. *Depreciation*

Under the proposed option, the incentive depreciation system ould group assets into 6 classes, generally according to the depre-ation periods that currently apply for property leased to tax-xempt entities. This period is in most cases an asset's midpoint fe under the Asset Depreciation Range system (ADR). The recov-ry classes and recovery periods would be as follows:

ADR midpoint	Recovery class	Recovery period (years)
ſnder 5	1	3
to 6.5	2	5
to 10.5	3	7
1 to 17.5	4	11
8 to 34.5	5	18
5 and over	6	30

Low income housing would be in Class 5. Other structures that o not currently have an ADR midpoint would be in Class 6. The ecovery method for Classes 1 through 5 would be 150-percent de-lining balance, switching to straight-line; for Class 6 it would be traight line. In general, property that does not now qualify for the ıost accelerated depreciation would be depreciated under the rules urrently applicable to tax-exempt use property.

As under present law, depreciation deductions would not be in-exed for inflation. Gain on disposition would be recaptured as or-inary income to the extent of previously allowed depreciation for ll property. The present election to expense property would be mited to taxpayers whose annual total investment is $200,000 or ess, and the amount that could be expensed would be increased rom $5,000 to $10,000 per year.

These provisions would generally apply to property placed in ervice after December 31, 1985. Transition rules would be provided or certain investments placed in service after this date if a binding ontract was in effect or construction began before September 26, 985.

?. *Recapture of Excess Accelerated Depreciation*

The proposed option has no provision with respect to the recap-ure of excess accelerated depreciation contained in the President's roposal.

C. Investment Tax Credit

The proposed option is generally the same as the President's pr posal: the regular investment tax credit would be repealed fc property placed in service after December 31, 1985. However, th credit would be available for property placed in service on a late date if the property qualifies for present-law depreciation unde the proposed depreciation transition rules. In order to compensat for the enhanced value of the credits as a result of the rate cut credits earned on transition property would be spread over 5 year and a basis adjustment for the full credit would be required in th first taxable year.

The proposed option would also repeal the finance lease rules, e fective January 1, 1986 (January 1, 1988, for property that qualifie for finance lease transition rules under prior tax acts).

D. Rapid Amortization Provisions

The proposed option generally follows the President's propos (with certain additional transition rules) in repealing rapid amort zation elections for certain costs relating to trademarks and trad names, certified pollution control facilities, qualified railroad grad ing and tunnel bores, soil and water conservation, and fertilize and soil conditioning.

However, the proposed option would retain the present law ele tion to amortize over 60 months certain qualifying costs for reha bilitation of low-income housing. The proposed option would re place the present law limits of $20,000 per dwelling unit ($40,000 i some cases) with a single $30,000 per dwelling unit limit.

E. Other Capital-Related Costs

1. *Deduction for research expenditures and incremental researc tax credit*—The proposed option would include an anti-"double dip ping" rule so that no deduction would also be allowed for researc expenditures on which a tax credit is allowed.

The incremental research credit would be extended through 198 (as in the President's proposal). The credit rate would be reduce from 25 to 20 percent, and in computing the credit for the curren year, prior-year expenditure amounts would be adjusted to reflec inflation. Under the proposed option, the definition of qualified re search expenditures would be tightened; also, rental equipment ex penses would not be eligible for the credit, consistent with th treatment of purchased equipment. The research credit would b subject to the same general limitation (as a percentage of tax liabil ity) as other business credits.

2. *Tax credit for rehabilitation expenditures.*—The propose option would replace the 15- and 20-percent credits with one 10-per cent credit, and limit the new 10-percent credit to buildings con structed before 1935. The 25-percent credit for certified histori structures would be reduced to 20 percent, and depreciable basi would be adjusted downwards by the full amount of the credit

'hese proposals would be effective for property placed in service on r after January 1, 1986, subject to transition rules for certain roperty placed in service before January 1, 1988. Credits claimed inder the transition rules would be reduced from 15 percent to 10 ercent, from 20 percent to 13 percent, and from 25 percent to 20 ercent (with a full-basis adjustment for historic structures).

3. *Merchant Marine Capital Construction Fund.*—The proposed ption is the same as the President's proposal: No tax-free contri-utions to capital construction funds could be made after December 1, 1985, except with respect to vessels owned on January 1, 1986, r vessels with respect to which the taxpayer performs a substan-ial amount of construction or reconstruction before January 1, 986. Amounts remaining in a capital construction fund on Janu-ry 1, 1996, would be treated as withdrawn at that time.

4. *Tax credit for orphan drug clinical testing.*—The proposed ption is the same as the President's proposal: the tax credit would xpire after 1987, as provided under present law.

5. *Investment tax credit limitation.*—The proposed option is to educe the limit on taxable income against which the investment ax credit can be used from 85 percent to 75 percent, effective for axable years beginning after December 31, 1985.

'. *Capital Gains and Losses*

1. *Individual long-term capital gain tax rate.*—The proposed ption would provide a 40 percent exclusion for long-term capital ain (rather than 50 percent, as under the President's proposal). Given the maximum 35 percent individual tax rate under the pro-osed option, the maximum individual long-term capital gain rate vould be 21 percent (rather than the present law 20 percent).

Long-term capital gains of corporations would be taxed at the roposed option's regular corporate rates (up to 35 percent).

2. *Assets eligible for long-term capital gain treatment.*—The pro-osed option generally follows present law rather than the Presi-lent's proposal, in that the proposed option would not index the asis of depreciable assets used in a trade or business, and would ot require ordinary income treatment of all gain on dispositions of rade or business property that is presently eligible for capital gain reatment. However, the proposed option would expand the present aw rules that require recapture as ordinary income of previously leducted items such as depreciation. Under the proposed option, all previously taken depreciation on real property would be recap-ured, as is the case for personal property under present law. Other previously deducted or expensed items (apart from research and ex-perimental expenditures) that if not deducted would be reflected in asis would also generally be recaptured.

The proposed option would generally follow the President's pro-posal with respect to treatment of coal, domestic iron ore and timber. (See Items I.1. and I.2., below.)

G. Oil and Gas

1. *Depletion.*—The proposed option would phase out percentag depletion for oil and gas over a 3-year period, beginning with prc duction after 1985.

2. *Intangible drilling costs.*—Under present law, intangible dril ing and development costs (IDCs) generally may be deducted cu rently (i.e., expensed). In the case of integrated producers, 80 pe cent of IDCs may be expensed and the remaining 20 percent mus be amortized over a 36-month period.

Under the proposed option, the expensing of IDCs would contir ue as under present law. In the case of producing wells, howeve expensed domestic IDCs would be included in income (i.e., recap tured) at the time the well commences production. Recapture amounts (and IDCs incurred after the well is placed in service would then be recovered at the fastest depreciation rate allowed fo equipment, i.e., Class 1 (3-year recovery period). IDCs on all well outside the United States would be recovered either by (1) 10-yea amortization, or (2) cost depletion, at the election of the taxpaye

These proposals would each be effective for costs paid or incurre after 1985.

3. *Tertiary injectants.*—Under present law, tertiary injection ex penditures may be deducted in the year of injection. Under the prc posed option, beginning after 1985, one-half of such expenditure could be deducted in the year of injection and the remaining one half in the next year.

H. Hard Minerals

1. *Exploration and development costs.*—Under present law, har mineral exploration and development costs may be expensed by in dividual taxpayers. In the case of corporations, 80 percent of thes costs may be expensed, and the remaining 20 percent is recovere in the same manner as 5-year depreciable property. At the taxpay er's election, once a mine begins production, expensed exploratio (but not development) costs either (1) reduce depletion deductions or (2) are recaptured in income and then recovered through deple tion.

The treatment of hard minerals would generally follow that pro vided for oil and gas. Under the proposed option, for domesti mines, both exploration and development costs that are expense would be recaptured when the mine reaches the producing stage Recaptured amounts (and development costs incurred after produc tion commences) would be recovered in the same manner as depre ciable property in Class 1 (3-year recovery period). The 20 percen of corporate exploration and development costs that are not ex pensed would be recovered in the same manner as Class 2 deprecia ble property (5-year recovery period), beginning in the year th costs are paid or incurred.

The proposed option would further require that foreign explora tion and development costs be recovered by (1) 10-year amortizatio or (2) cost depletion, at the election of the taxpayer.

These proposals would be effective for costs paid or incurre after 1985.

2. *Depletion.*—The proposed option would phase out percentage epletion of hard minerals over a 3-year period, beginning with roduction after 1985.

. ***Capital Gain Rules for Coal, Iron Ore, and Timber***

1. *Capital gain treatment for coal and domestic iron ore royalies.*—The proposed option would follow the President's proposal by hasing out the special capital gain treatment for coal and domesic iron ore royalties over a 3-year period, beginning with royalties eceived after 1985.

2. *Capital gain rules applicable to timber.*—The proposed option ould follow the President's proposal by phasing out these special ules over a 3-year period, beginning after 1985.

. ***Energy Credits and Other Incentives***

1. *Residential energy credits.*—The proposed option would follow he President's proposal, by allowing thesecredits to expire after 985 as under present law.

2. *Business energy credits.*—The proposed option generally would ollow the President's proposal, allowing these credits to expire fter 1985, but retaining present law carryover provisions for nused credits. However, the proposed option would modify the resident's proposal by requiring that credits allowable under resent-law affirmative commitment rules be spread out over the 5 ears remaining before expiration of this provision (i.e., 20 percent f the otherwise allowable credit for any year could be taken in ach of the remaining 5 years).

3. *Credit for fuels from nonconventional sources.*—The proposed ption would follow the President's proposal: the credit would terninate after December 31, 1985, with a transitional provision alowing the credit for fuel produced from a well drilled, or facility ompleted, before January 1, 1986, and which is sold before Janury 1, 1990.

4. *Alcohol fuels credit and tax exemptions.*—The proposed option s the same as the President's proposal: (1) the 60-cents-per-gallon redit for alcohol fuels would be available only for alcohol fuels roduced from facilities completed before January 1, 1986, and sold efore January 1, 1993; (b) the excise tax exemptions for gasohol (6 ents per gallon) and alcohol fuels (9 cents per gallon) would be reealed after 1985; and (c) the 60-cents-per-gallon import duty on alohol imported into the U.S. for fuel use would continue through 992. These provisions are all scheduled to expire after 1992 under resent law.

III. Corporate Taxation

A. Corporate Tax Rates

The proposed option would provide a 4-bracket graduated corpc rate tax rate structure as follows:

Taxable income:	*Rate (percen*
$25,000 or less	1
Over $25,000 but not over $50,000	1
Over $50,000 but not over $75,000	3
Over $75,000	3

This structure retains the present law 30-percent rate for th $50,000-$75,000 bracket and provides a top corporate rate of 35 pe cent, rather than the President's proposed 33 percent.

Under the proposed option (as under the President's proposal the benefit of graduated rates would be phased out for highe income corporations. Under the proposed option, corporation having taxable income of $350,000 or more would, in effect, pay ta at a flat 35-percent rate.

The proposed option would repeal the present law alternative ta rate of 28 percent on a corporation's long-term capital gain. Sucl capital gain would be taxed at regular corporate rates.

These corporate rate changes would be effective for taxable year beginning on or after January 1, 1986.

B. Dividends Paid Deduction and Dividends Received Deduction

The proposed option would phase in the President's proposed 10 percent dividends paid deduction over 10 years. The deductior would be 1 percent for dividends paid in taxable years beginnin after January 1, 1987, increasing 1 percent each year to 10 percen for taxable years beginning after January 1, 1996.

The present law intercorporate dividends received deductior (generally 85 percent, 100 percent for certain affiliates) would b retained but adjusted to reflect the payor's dividends paid deduc tion. Thus, for example, the 85-percent dividends received deduc tion would be reduced to 84 percent when the dividend paid deduc tion is first effective and to 75 percent after the 10-year phase-in

Where a dividends paid deduction is taken, the proposed optior would impose compensatory taxes in certain circumstances on percent or greater tax-exempt shareholders and on certain foreigr shareholders not covered by the President's proposal.

C. Dividend Exclusion for Individuals

The proposed option follows the President's proposal and woulc repeal the $100 ($200 joint return) dividend exclusion for individ uals.

). *Treatment of Stock Redemption Payments*

The proposed option would provide that no portion of payments ›y a corporation in redemption of its own stock is deductible. This vould clarify present law as some corporations have taken the poition that stock redemption payments for the purpose of preventng a hostile takeover (so-called "greenmail" payments) are deductble as ordinary business expenses.

፤. *Special Limitations on Net Operating Loss Carryovers*

The proposed option is to limit the earnings against which a ŃOL carryover can be used after a more-than-50-percent change in ›wnership, rather than reducing or eliminating the NOL carryover tself (as under present law). The proposal would be effective for acluisitions on or after January 1, 1986, and reorganizations pursuınt to plans adopted on or after that date.

?. *Employee Stock Ownership Plans (ESOPs)*

1. *ESOPs as employee benefit plans.*—The proposed option would ıccelerate the repeal of the payroll-based ESOP tax credit, and ·etain the special present law limits on employer deductions and ›verall limits, without adopting the President's ESOT proposal.

In addition, the proposed option would require an ESOP to pro-ride expanded pass-through of voting rights and more immediate listribution of ESOP securities, subject to a put option.

2. *Incentives for ESOP Financing.*—The proposed option would ·epeal the ESOP deduction for dividends paid, the exclusion of in-erest on certain ESOP loans, the tax-deferred rollover of gain de-·ived from sales of stock to an ESOP or cooperative, and the provi-sion permitting an ESOP or cooperative to assume certain estate :ax liability.

IV. Tax Shelters

A. At-Risk Rules

The at-risk rules limit the net losses which individuals and certain corporate taxpayers may deduct with respect to an activity. Present law provides an exception from the rules for the activity of holding real estate. The proposed option follows the President's proposal to repeal this real estate exception, effective for losses attributable to property acquired after December 31, 1985.

B. Investment Interest Limitation

1. *General limitation.*—The deduction for nonbusiness interest expense of noncorporate taxpayers, in excess of their net investment income, would be the greater of (a) interest on debt secured by the taxpayer's principal residence to the extent of its fair market value, or (b) $20,000. Housing cooperatives may qualify under (a) subject to appropriate limitations.

2. *Interest subject to limitation.*—Nonbusiness interest subject to the limitation means all interest (including consumer interest) not incurred in a trade or business, including the taxpayer's share of interest expense attributable to certain passive investments.

3. *Investment income defined.*—Net investment income includes dividends, interest, rents, royalties, and similar items, the taxpayer's share of income attributable to certain passive investments and the taxable portion of capital gains. Investment expenses, which are netted against this income to determine net investment income, include expenses and depreciation and depletion actually deducted.

4. *Net leases.*—Property subject to a net lease is considered an investment, unless the business deductions exceeds 15 percent of the rental income. If the taxpayer performs personal services with respect to directly owned leased property, the value of his services may be included with his business deductions, in calculating 15 percent of rental income.

5. *Rental property.*—The present law rules applicable to allocation of business expenses, in the case of rental property used for both business and personal purposes, would be applied to determine the allocable portion of business interest not subject to the limitation.

Effective date.—Subject to a phase-in rule, the limitation would be effective for interest paid or incurred in taxable years beginning on or after January 1, 1986, regardless of when the obligation was incurred. Interest not subject to the limitation under present law, but which would be subject to the expanded limitation, would become subject to the limitation ratably (10 percent per year) over 10 years commencing with taxable years beginning in 1986. Thus, 100 percent of interest subject to the expanded limitation would have become subject to it in taxable years commencing in 1995.

V. Minimum Tax

A. *Individual Minimum Tax*

Under the proposed option, the present law individual alternative minimum tax would be retained with the following modifications. The rate would be increased to 25 percent; accelerated depreciation on all property placed in service after 1985 would be a preference; the net income offset to the intangible drilling cost preference would be deleted; the preference for research and development expenses would be the deduction in excess of 5-year amortization; interest on newly issued nongovernmental obligations, excludable income earned abroad by U.S. citizens, the benefits of the completed contract method of accounting, net losses from passive investment activities, and charitable contributions of appreciated property would be added as preferences; and a credit would be allowed against the regular tax for prior years' minimum tax liability. The provision would apply to taxable years beginning after December 31, 1985.

B. *Corporate Minimum Tax*

An alternative minimum tax, similar to the individual minimum tax, would replace the present law add-on tax. The rate would be 25 percent, and a $40,000 exemption would be allowed. The items of tax preference would be accelerated depreciation on all property (i.e., the excess claimed over that allowable under the nonincentive rules) placed in service after 1985, excess amortization of pollution control facilities, percentage depletion in excess of basis, excess mining exploration and development costs, intangible drilling costs in excess of 10 year (or cost depletion) amortization, research and experimentation expenses in excess of 5-year amortization, tax-exempt interest on newly issued nongovernment obligations, excludable FSC income, the benefit of completed contract method of accounting, and charitable contributions of appreciated property. Rules similar to the individual minimum tax proposal would apply to incentive credits, foreign tax credit, minimum tax credit and net operating losses. Estimated tax payments of the minimum tax would be required. The provision would apply to taxable years beginning after December 31, 1985.

VI. Foreign Tax Provisions

A. Foreign Tax Credit

1. *Foreign tax credit limitation.*—The overall foreign tax credi limitation of present law would be retained. The separate limitation for interest income would be replaced with a separate limitation for low-tax income. Low-tax income would be defined by reference to certain categories of income subject to the anti-tax haven rules.

2. *Creditability of "in lieu of" taxes.*—Foreign levies on interes paid to financial institutions would be creditable "in lieu of" taxe only up to the amount of the general income tax of the levyin country.

3. *Deemed-paid credit.*—The proposed option is the same as th President's proposal: (a) the deemed paid credit for a U.S. corporation's share of foreign taxes paid by a foreign corporation woul depend upon the foreign corporation's multi-year pool of accumulated earnings and profits; and (b) earnings and profits generall would be computed in the same manner for actual distributions a they are now for tax-haven income inclusions.

4. *Effect of losses on foreign tax credit.*—Present law would generally be retained, but foreign source losses would reduce all type of foreign source income before reducing U.S. source income.

B. Source Rules

1. *Income derived from purchase and sale of inventory-type property.*—As stated in the President's proposal (but with additiona anti-abuse rules), source would generally be determined by th country of residence of the seller (the place-of-title-passage sourc rule of present law would be repealed). Following the President' proposal, when a seller has a fixed place of business outside his residence country that participates materially in a sale to an unrelated party, the sales income generally would be sourced in the country in which that fixed place of business is located.

2. *Income from manufacture and sale of inventory-type property.*— The proposed option would specify that at least 50 percent of such income must be allocated to manufacturing activity, which would be sourced in the manufacturer's country of residence. The portion of such income allocated to sales activity will be sourced under the rules for sales income described immediately above.

3. *Income from intangible property.*—With respect to royalty income, the proposed option is the same as the President's proposal: retain the place-of-use source rule of present law. With respect to sales income, the proposed option is the same as the proposed option set forth above for income from the purchase and sale of inventory-type property, except for income from sales for amounts contingent on the use of an intangible.

4. *Income derived from sale of other personal property.*—Under the proposed option, recapture income derived from sales of personal property used by the seller in a business would be sourced where deductions with respect to such property previously offset income. Income in excess of those deductions would be sourced like income from sales of inventory-type property. Following the President's proposal, income derived from sales of other personal property, including passive investment property, would be sourced in the country of residence of the seller.

5. *Transportation income.*—The proposed option would source transportation income from United States-foreign routes as 50-percent U.S. source income and 50-percent foreign source income. (Present law generally treats most transportation income earned on such routes as foreign source income.) Following the President's proposal, the special U.S. sourcing rule for income and expenses associated with vessels or aircraft constructed in the United States and leased to U.S. persons would be repealed, subject to a grandfather rule for currently leased assets. The proposed option would also repeal a similar rule for transportation income earned in leasing certain aircraft used on United States-U.S. possessions routes.

Under the proposed option, the reciprocal tax exemption for foreign persons' shipping and aircraft income would be available only if a foreign person's country of residence gives U.S. persons an equivalent foreign tax exemption; in addition, a four-percent gross basis tax would be imposed on U.S. source shipping income of foreign persons.

6. *Other offshore income and income earned in space.*—The proposed option would source other offshore income and income earned in space in the recipient's country of residence.

7. *Dividend and interest income.*—The proposed option would treat interest and dividends paid by a U.S. corporation that earns more than 80 percent of its income from foreign sources (an "80/20" company) as foreign source to the extent that the company's income is derived from foreign sources in the active conduct of a trade or business outside the United States. (The President's proposal would treat all such income as U.S. source, thereby generally repealing the 80/20 foreign sourcing exception of present law.) For foreign tax credit purposes, the proposed option would treat 80/20 companies' dividends and interest payments as U.S. source unless they are connected with an active financing business of an unrelated U.S. payee conducted outside the United States. The proposed option would include the President's proposal to restructure certain interest income exemptions.

8. *Allocation of interest and other expenses.*—The proposed option generally would require corporate members of affiliated groups to allocate all expenses between U.S. and foreign income on a consolidated group basis. Certain corporations that cannot join in filing consolidated returns could continue to allocate expenses on a separate company basis as could some financial and similar companies if their borrowing and lending activities are independent from their affiliates' other operations. The asset method of allocating interest expense would be modified and the optional gross income method would be eliminated. Tax-exempt income and assets would not be taken into account for purposes of allocating expenses. The

new consolidated allocation rules would be phased in over three years in the case of interest paid on preexisting loans.

C. U.S. Taxation of Income Earned Through Foreign Corporations

1. *Tax haven income subject to current tax*

a. Tax haven income generally.—Certain types of income would be added to foreign personal holding company (FPHC) income for purposes of the Code's anti-tax haven rules. Certain exceptions to these rules would be repealed, including the exclusion for reinvested shipping income. The subjective tax-avoidance safe-harbor rule would be replaced with an objective test.

b. Determination of U.S. control of foreign corporations.—The U.S. ownership requirement for imposition of the anti-tax haven rules would be amended. For the anti-tax haven rules to apply to a foreign corporation, 50 percent or more (rather than more than 50 percent) of the vote or value (not merely vote) of that corporation would have to belong to 10-percent U.S. shareholders. Similarly, for the foreign personal holding company rules to apply, 50 percent or more of the vote or value of a foreign corporation would have to be owned by five or fewer U.S. individuals. Transition rules would be provided.

c. De minimis tax haven income rule.—Present law would be amended to apply the de minimis and 70-percent rules for foreign base company income on the basis of earnings and profits instead of gross income.

d. Foreign investment companies (FICs).—Present law would be amended to require current recognition of gain or loss accrued by U.S. investors in FICs, and to apply FIC rules to U.S. investors in foreign funds irrespective of the degree of aggregate U.S. ownership in the funds.

e. Possessions-chartered corporations.—The proposed option is the same as the President's proposal: the exception to the anti-tax haven rules for possessions-chartered corporations would be repealed, with appropriate transition rules provided.

2. *Application of accumulated earnings tax (AET) and personal holding company (PHC) tax to foreign corporations*

Present law would be amended to exclude capital gains and losses, for purposes of calculating the AET or PHC tax, only if they are effectively connected with the conduct of a U.S. trade or business.

3. *Election to be treated as a U.S.corporation*

Present law would be amended to permit certain controlled foreign corporations to elect treatment as domestic corporations for U.S. tax purposes, subject to rules preventing tax avoidance.

D. Special Tax Provisions for U.S. Persons

1. *Possession tax credit*

The proposed option would retain the existing possession tax credit with certain modifications. With respect to income generated from intangibles transferred to the possessions, the optional cost sharing method of allocating intangible income would be repealed. The credit allocable to passive income of a possession corporation would be limited to one-half of the U.S. tax on such income. These changes would apply to taxable years beginning after 1985. Similar rules would apply to U.S. operations in the U.S. Virgin Islands. The wage credit proposed by the President would not be adopted.

2. *Other rules with respect to U.S. possessions*

a. U.S. Virgin Islands.—Under the proposed option, the mirror tax system of the Virgin Islands would be eliminated after 1985. This generally follows the treatment proposed by the President for the other possessions except that for interested purposes the Virgin Islands would continue to use the mirror code as in effect prior to the tax reform legislation (rather than as modified by that and subsequent legislation) until it enacted its own tax law. Following the President's proposal, the Virgin Islands inhabitant rule would be repealed. To be exempt from U.S. withholding tax, 65 percent of a Virgin Islands corporation's income would have to be effectively connected with a trade or business in a possession or in the United States.

b. Guam, the Northern Mariana Islands (NMI), and American Samoa.—The proposed option is generally the same as the President's proposal: after 1985, full authority would be granted to Guam and the NMI to determine their own income tax laws (as American Samoa presently does); the President proposes that the systems implemented by Guam and the NMI raise as much revenue as the current mirror system; residents of Guam and the NMI with income from outside the possessions must file U.S. tax returns; the United States would collect the tax on such income and transfer the money to the possessions; to avoid U.S. withholding tax, 65 percent of a possession corporation's income must be effectively connected with a trade or business in a possession or in the United States. Under the proposed option, until each jurisdiction enacted its own laws, its mirror code would apply for internal purposes, by reference to the Code in effect prior to the tax reform legislation.

3. *Taxation of U.S. employees of Panama Canal Commission*

The proposed option would clarify that the Agreement in Implementation of Article III of the Panama Canal Treaty does not exempt U.S. taxpayers from U.S. tax.

4. *Foreign Sales Corporations (FSCs)*

The proposed option would change the reduction in taxable income for FSC shareholders from 16% to 14% of export income (from 15% to 13% for corporate shareholders) after 1985. Corresponding changes would be made to DISC rules.

5. *Private sector earnings of Americans abroad*

The proposed option would reduce the maximum annual exclusion for foreign earned income of Americans working abroad, from the present $80,000 to $50,000.

E. Foreign Taxpayers

1. *Branch-level tax.*—The proposed option would reduce the present 50-percent U.S. source income threshold for the imposition of withholding taxes on payments of interest and dividends by foreign corporations. The branch-level and modified interest withholding taxes proposed by the President as substitutes for the present dividend and interest withholding taxes would not be adopted.

2. *Retain character of effectively connected income.*—The proposed option would treat income or gain as effectively connected with a U.S. trade or business if it is attributable to a different taxable year and would have been so treated if it had been taken into account in the other year.

3. *Tax-free exchanges by expatriates.*—The tax-avoidance expatriate rules under present law would be applied to gains on the sale of property the basis of which was determined by reference to U.S. property.

4. *Excise tax on insurance premiums paid to foreign insurers.*—The proposed option would make the excise tax on casualty reinsurance premiums paid after 1985 to foreign insurers for U.S. risk coverage equal to that on similar casualty insurance premiums (4 percent), make the foreign insurer liable for the tax, and require the U.S. insured or broker obligated to transmit the premiums to withhold the tax.

F. Foreign Currency Exchange Gain or Loss

The tax treatment of exchange gain or loss, including character, source, and timing, would be clarified. Generally, exchange gain or loss would arise if the exchange rate fluctuates between the date an item is taken into account for tax purposes and the date it is paid. In general, exchange gain or loss would be ordinary in nature. All business entities that account for foreign operations in a foreign currency would be required to use a profit and loss translation method. For purposes of the foreign tax credit, a foreign tax would be translated at the exchange rate in effect on the payment date. The indirect foreign tax credit would be calculated on the basis of the exchange rate in effect on the date the tax was paid by the subsidiary, and the exchange gain or loss on the distributed earnings would be treated as separate basket foreign source income.

VII. Tax-Exempt Bonds

A. General Restrictions on Tax-Exemption

The proposed option would permit States and local governments to continue to finance traditional governmental activities such as schools, highways, government buildings, governmental solid waste and sewage disposal systems, and governmental water and electric facilities, as well as operating expenses of the governments themselves.

The 1-percent rule of the President's proposal would be liberalized to permit a portion of governmental bond proceeds equal to the lesser of 5 percent or $5 million to be used by persons other than governmental units.

B. Tax-Exempt Bonds for Certain Nongovernmental Activities

The proposed option would permit continued tax-exempt financing for certain nongovernmental exempt facilities, and for exempt activities of section 501(c)(3) organizations (subject to certain restrictions).

The exempt facilities qualifying for tax-exempt financing would be—

(1) Multifamily rental housing, redefined to provided greater targeting to lower income individuals;

(2) Certain airport facilities;

(3) Certain dock and wharf facilities;

(4) Certain facilities for the furnishing of water; and

(5) Sewage and solid waste facilities defined generally as under present law.

In addition, both qualified mortgage bonds (subject to revised targeting rules) and qualified veterans' mortgage bonds would be continued under the proposed option.

Nongovernmental property financed with tax-exempt bonds would be required to be owned by a State or local governmental unit (or by a section 501(c)(3) organization). This restriction would not apply to residences financed with mortgage subsidy bonds and multifamily rental housing. Various other rules presently applicable to IDBs would be extended to all nongovernmental bonds. Finally, provisions would be provided to ensure continued use of bond-financed nongovernmental property in a use qualifying for such financing.

C. Volume Limitation on Nongovernmental Bonds and Bond Proceeds

A single annual volume limitation would apply to all nongovernmental bonds (other than certain airport bonds) and to the portion of a governmental bond issue in excess of $1 million that was used by persons other than a State or local government. (Under the rules discussed above, the maximum amount of a governmental bond issue that could be so used would be an amount equal to the lesser of 5% of proceeds or $5 million.)

The annual nongovernmental bond volume limitation for each State and local issuers therein would be an amount equal to $150 per resident of the State (reduced to $100 per capita after 1987 to reflect the presently scheduled qualified mortgage bond sunset). Unless a State statute provided otherwise, at least 50% (25% after 1987) of its volume limitation would be reserved for housing issues.

D. Arbitrage Restrictions

The proposed option generally would adopt the rules of the President's proposal. Thus, the present-law IDB rebate requirement and investment restrictions would be extended to all bonds, early issuance of bonds would be restricted, and temporary periods during which unlimited arbitrage may be earned would be limited.

The proposed option follows the President's proposal to prohibit advance refundings of all tax-exempt bonds. Advance refundings would be defined as any refunding occurring more than 30 days before the refunded bonds are redeemed.

Additionally, the arbitrage consequences of investing bond proceeds in third party annuity contracts would be conformed to the treatment of such proceeds invested directly in State or local government pension programs, effective for bonds issued after September 25, 1985.

E. Information Reporting Requirement for All Tax-Exempt Bonds

The present-law information reporting requirements applicable to private activity bonds would be extended to all tax-exempt bonds.

F. General Stock Ownership Corporation Provisions

The GSOC provisions of present law would be repealed as deadwood.

G. Effective Dates

The proposed option generally would apply to bonds issued after December 31, 1985. Transitional exceptions to certain of the provisions would be permitted for projects in progress before September 26, 1985, and for limited refundings of bonds that could no longer be issued under the option.

VIII. Financial Institutions

A. Reserves for Bad Debts

1. *Commercial banks.*—Under the proposed option, for taxable years beginning after 1985, banks would not be allowed to deduct loan losses prior to the time that loans become wholly or partially worthless. Accumulated bad debt reserves on the effective date would be included in income over a 6-year period starting with the first taxable year beginning after 1985. Banks could elect the amount of reserves to be recaptured in the first taxable year, and ratably recapture the balance over the next 5 years. The President's proposal would recapture accumulated reserves over a 10-year period.

2. *Thrift institutions.*—Under the proposed option, for taxable years beginning after 1985, thrift institutions would not be allowed to deduct loan losses prior to the the time that loans become wholly or partially worthless. A portion of accumulated bad debt reserves on the effective date would be included in income over a 6-year period starting with the first taxable year beginning after 1985. The recapture amount is the greater of the reserve balance (1) computed as of December 31, 1985 using the experience method, and (2) computed as June 30, 1985 using the percentage of eligible loans method. Thrifts could elect the amount of reserves to be recaptured in the first taxable year, and ratably recapture the balance over the next 5 years.

Elective cut-off method.—As an alternative to recapture, thrifts could elect to retain the reserve method for loans originated or acquired before 1986. Losses on existing loans (including collateral property) would be charged off against bad debt reserves to the extent of the recapture amount. Losses in excess of the recapture amount would be deductible from gross income. However, sale of existing loans would trigger inclusion in income of a pro rata share of the recapture amount. The President's proposal would recapture a portion of accumulated reserves over a 10-year period, and would not allow use of the elective cut-off method.

Distributions in excess of earnings and profits (accumulated after 1951) would be treated as made out of bad debt reserves (to the extent such reserves exceed the amount of reserves determined using the experience method), as under present law.

B. Interest on Debt Used to Purchase or Carry Tax-Exempt Obligations

Under present law, 20 percent of financial institution interest deductions that are allocable to tax-exempt obligations acquired after 1982 are disallowed. Under the President's proposal and the proposed option, 100 percent of interest deductions allocable to tax-exempt obligations acquired after 1985 would be disallowed. The proposed option would provide special rules coordinating this rule with other provisions prescribing special treatment of interest deductions (e.g., construction period interest rules and rules regarding foreign source income).

C. Reorganizations of Financially Troubled Thrift Institutions

Under present law, certain financially troubled thrift institutions are entitled to special tax treatment: (1) mergers of such thrifts qualify for tax-free status without continuity of proprietary interest; (2) the rules limiting the use of net operating losses by an acquiring corporation are relaxed; and (3) payments received by such thrift institutions from FSLIC are not income to the recipient and do not reduce the recipient's basis. Under the proposed option, these special tax rules would be repealed after 1985. The President's proposal would repeal these rules after 1990.

D. Credit Unions

The President's proposal and the proposed option would repeal the tax-exempt status of credit unions having assets of $5 million or more for taxable years beginning after 1985. Large credit unions generally would be subject to the same tax rules as apply to thrift institutions.

E. Special Rules for Net Operating Losses of Depository Institutions

Under present law, commercial banks and thrift institutions may carry net operating losses (NOLs) back 10 taxable years and forward 5 taxable years. Under the President's proposal and the proposed option, depository institutions would be subject to the same NOL carryover rules as other taxpayers (i.e., 3-year carryback and 15-year carryforward). The proposal applies to NOLs incurred in taxable years after 1985.

IX. Accounting Issues

A. Limitations on the Cash Method of Accounting

The proposed option would deny the use of the cash method of accounting to businesses with annual gross receipts in excess of $5 million and all non-farm businesses which report on a non-cash basis for certain purposes, as in the President's proposal, with the following changes and clarifications.

—Income accrual would be limited to the statistically determined collectable amount if interest or late charges are not separately stated.

—Reporting to creditors on a method other than cash, in accordance with the forms or models of the creditor, would not cause denial of the use of the cash method, unless done on a regular basis.

—Annual gross receipts would be computed using the gross receipts of the previous 3 taxable years.

B. Pledges of Installment Obligations

The proposed option would require that the proceeds of a loan for which an installment obligation is pledged are generally to be treated as a payment on the installment obligation, as in the President's proposal, with the following changes and clarifications.

—All pledges would be treated as a payment on the installment loan and income recognized using the gross profit ratio.

—Portion of installment payments due within 6 months would be excepted. The appropriate portion of installment obligations created on a revolving credit plan would be statistically determined.

—90-day debt issued by the taxpayer would be excepted only if additional debt is not issued within 45 days.

—Certain anti-avoidance rules would be provided.

—Applicable to installment debt pledged on or after January 1, 1986. Installment debt created after September 25, 1985, would be considered pledged on January 1, 1986, if previously pledged for a note outstanding as of that date. Any installment obligation created before September 26, 1985, and pledged before January 1, 1986, would be treated as pledged on January 1, 1991, if the debt for which the installment obligation was pledged is still outstanding at that time.

C. Accounting for Production Costs

The proposed option would generally follow the President's proposal and

—Require that the comprehensive capitalization rules generally applicable to extended period long term contracts generally apply to all activities involving the production of real or personal property.

—Require capitalization for farm products only where the productive life of the product is 2 years or longer, unless inventories are otherwise required to be kept.

—Require capitalization of interest on debt incurred to finance long-lived property used in a business or other tangible property requiring 2 years or longer to construct or reach a productive stage.

For timber planted before 1986, capitalization of the additional costs would be phased in over a 5-year period (rather than a 10-year period as in the President's proposal).

The proposed option would repeal the completed contract method of accounting and require income on long term contracts to be reported on the percentage of completion method, with interest payable by (or to) the taxpayer if the actual profit on the contract varies from the estimated profit used in reporting income. This change would apply to contracts entered into after September 25, 1985.

D. Special Treatment of Certain Items

1. *Reserves for bad debts.*—The proposed option would deny the use of the reserve method in computing the deduction for bad debts, as in the President's proposal, as well as the use of the reserve method for losses on the guarantee of debt by dealers. Any balance in such a reserve would be included in income ratably over 6 years, rather than over 10 years as in the President's proposal, in order to provide more consistency with other transitional rules for accounting method changes.

2. *Mining and solid waste reclamation costs.*—The proposed option would allow taxpayers to continue to elect to use a reserve method for deducting qualified mine and waste disposal reclamation and closing costs prior to economic performance. The President's proposal would have repealed this election.

3. *Accrued vacation pay.*—The proposed option would defer an employer's deduction for accrued vacation pay expenses until the employee included an equal amount in gross income, unless the vacation pay is paid within 2-1/2 months after the end of the employer's taxable year.

4. *Returns of magazines, paperbacks and records.*—The proposed option would repeal the election to exclude from income of a taxable year amounts repaid or credited on account of the return of such an item after year end, as in the President's proposal.

5. *Qualified discount coupons.*—The proposed option would repeal the election to deduct the cost of redeeming discount coupons outstanding at the close of the taxable year and presented for redemption within the first 6 months of the following taxable year, as in the President's proposal.

X. Insurance Products and Companies

A. Insurance Products

1. *Life insurance products*

a. *Inside buildup.*—Under present law, the cash value of a life insurance policy earns interest ("inside buildup") that is not taxed as current income to the policyholder if the policy is not cashed in or surrendered for its cash surrender value. The proposed option would retain present law.

b. *Policyholder loans and partial withdrawals.*—The proposed option would provide that loans to policyholders under life insurance policies would be treated in the same manner as loans from qualified pension plans. Thus, policyholder loans would be treated as distributions to the extent of income on the contract, except to the extent the outstanding loan balances for an individual do not exceed $50,000 and the conditions of the loans require repayment within five years. Interest on policyholder loans would be treated as a nondeductible premium payment. The proposed option would generally be applicable only to loans made from policies issued after September 25, 1985.

c. *Exclusion for interest on installment payments of life insurance proceeds.*—The present law annual exclusion for up to $1,000 of interest on the unpaid proceeds of a life insurance policy paid to the surviving spouse of the insured would be repealed, effective after December 31, 1985.

2. *Other policyholder issues*

a. *Deduction for policyholder losses.*—The proposed option would retain present law, which provides that a taxpayer may generally deduct a loss sustained during the year except if he has a claim for reimbursement for which there is a reasonable prospect of recovery (such as an insurance claim). However, the proposed option would deny the loss deduction to the extent that an individual has insurance coverage on nonbusiness property and elects not to file a claim. The proposal would be effective for taxable years beginning after December 31, 1985.

b. *Structured settlements.*—Third-party assignees of liabilities to make periodic personal injury damage payments would include the full amount of consideration received from the assignor in income. An assignee purchasing an annuity contract to fund payment of the liability would be taxed on the income component of the annuity, and would be given an election concerning the timing of its deduction for payment of the liability. The proposed option would be effective for all assignments entered into after December 31, 1985.

B. Life Insurance Companies

1. *Reserves.*—The proposed option would retain present law permitting life insurance companies to deduct increases in life insurance reserves due to both premiums and interest credited to the reserves.

2. *Special deductions*

a. *Small company deduction.*—The small company deduction would be revised to provide a deduction for 50 percent of tentative life insurance company taxable income (LICTI) up to $1 million. The deduction would be phased out at $5 million of tentative LICTI. The maximum deduction would be $500,000 and would be allowed only to companies with gross assets of less than $100 million. The proposal would be effective for taxable years beginning after December 31, 1985.

b. *Special life insurance company deduction.*—The special deduction (20 percent of tentative LICTI) would be repealed as under the President's proposal, effective for taxable years beginning after December 31, 1985.

3. *Tax-exempt organizations engaged in insurance activities.*—Charitable or social welfare organizations directly engaged in the business of providing insurance would not be entitled to tax exemption, unless the organization provided insurance at less than cost to a class of charitable recipients. Fraternal beneficiary societies with annual gross premiums greater than $25 million would not be entitled to tax exemption. The proposal would be effective for years beginning after December 31, 1985.

C. Property and Casualty Insurance Companies

1. *Loss reserve deductions of property and casualty insurance companies.*—In lieu of adopting the President's proposal with respect to qualified reserve accounts (QRA), the proposed option would make changes in the treatment of reserves of property and casualty insurance companies with respect to (a) the treatment of acquisition expenses, (b) the treatment of tax-exempt income and deductible dividends received, (c) limits on consolidation with nonproperty and casualty companies, and (d) limits on the use of net operating losses. In addition, the proposal would phase in the cash method of accounting for property and casualty reserves (including accident and health reserves) for taxable years beginning after December 31, 1988.

2. *Limiting policyholder dividend deduction for mutual companies.*—The proposed option would require the Secretary of the Treasury to submit a study on the present-law treatment of policyholder dividend deductions of mutual property and casualty companies.

3. *Protection against loss account for mutual companies.*—The proposed option follows the President's proposal to repeal the deduction for additions to a protection against loss account.

4. *Special exemptions, rates, and deductions of small mutual companies.*—The proposed option would adopt a single small property and casualty company provision.

XI. Pensions and Deferred Compensation; Fringe Benefits

A. Tax-Favored Savings

1. *Spousal IRAs.*—Under the proposed option, the existing $2,250 limit on spousal IRAs would be retained, but no spouse with less than $250 of compensation would be precluded from receiving spousal IRA contributions.

2. *Cash or deferred arrangements (section 401(k) plans).*—The proposed option would limit the maximum annual elective deferral to $5,000 and coordinate that limit with the IRA deduction limit. The proposed option would also modify the special nondiscrimination tests applicable to qualified cash or deferred arrangements by redefining the group of highly compensated employees in whose favor discrimination is prohibited and by modifying the special percentage tests.

Employees could not be required to complete more than one year of service to be eligible to make elective deferrals, and no tax-exempt or public employers would be permitted to maintain a cash or deferred arrangement.

3. *Employer matching contributions.*—The proposed option would provide new nondiscrimination rules for qualifying employer matching contributions and voluntary employee contributions. The rules for qualifying contributions would be similar to those proposed for cash or deferred arrangements. Special rules would also be provided for nonqualifying contributions.

4. *Unfunded deferred compensation arrangements of State and local governments and tax-exempt employers.*—The proposed option would expand the definition of an eligible deferred compensation plan to include plans for employees of all tax-exempt employers.

5. *Deferred annuity contracts.*—The proposed option would require a taxpayer to include in income currently the increase in cash value over the owner's investment in the contract. An exception is provided to allow investments by individual owners of up to $100,000 in deferred annuity contracts the income on which would not be taxable currently. The additional tax on withdrawals before age 59-1/2 would be conformed to the additional tax for IRA withdrawals.

B. Minimum Standards for Qualified Plans

Coverage requirements.—The proposed option would replace the present law fair cross section and percentage tests with a new percentage test requiring that a qualified plan benefit at least 90 percent of all employees. Although the test generally would be applied on a controlled group basis, an exception would be provided for certain employers who, for bona fide business reasons, operated separate lines of business or operating units. The exception would permit an eligible employer to apply the test separately to each line of business, with respect to any plan benefiting at least 100 employees in which no more than 25 percent of the participants are highly compensated employees.

The proposed option would also redefine the group of employees treated as highly compensated for purposes of these rules.

Tax-sheltered annuities.—Effective for plan years beginning after December 31, 1986, the nondiscrimination rules applicable to qualified plans (as modified above) would be applied to tax-sheltered annuity programs maintained by tax-exempt organizations other than churches. In addition, salary reduction contributions under a tax-sheltered annuity program would be subject to the dollar limits and special nondiscrimination tests applicable to a cash deferred arrangement.

Nondiscrimination rule for defined benefit plans.—The proposed option provides that an employer would not be permitted to take into account an employee's security benefits earned with a prior employer in testing whether a plan is nondiscriminatory.

C. Withdrawal of Benefits

1. *Uniform minimum distribution rules.*—Under the proposed option, distributions under qualified plans, IRAs and tax-sheltered annuities would be required to commence no later than April 1 of the calendar year following the year in which the participant attains age 70-1/2. Uniform rules would prescribe the amount of required minimum distributions and impose an excise tax for failure to satisfy the minimum distribution rules.

2. *Withdrawals before age 59-1/2.*—The proposed option would preclude hardship withdrawals from a cash or deferred arrangement and would extend withdrawal restrictions to all tax-sheltered annuities. In addition, the proposed option would impose a 15-percent additional income tax on all distributions before age 59-1/2 made from qualified plans, tax-sheltered annuities or IRAs, unless the distribution is made on account of death or disability, or is payable in the form of a life annuity.

3. *Uniform treatment of distributions.*—The proposed option would generally follow the President's proposal regarding repeal of pre-1974 capital gains treatment, basis reordering rules, and 10-year forward averaging for lump sum distributions prior to age 59-1/2. However, rollover restrictions would be retained and only one election to claim 5-year forward averaging would be allowed for lump sum distributions after age 59-1/2. In addition, the present law treatment of net unrealized appreciation would generally be retained for all securities held by a plan as of December 31, 1985, and for all securities attributable to employee contributions.

4. *Loans under qualified plans.*—The proposed option would require level amortization of a loan over the permissible repayment period, defer certain deductions for interest paid on plan loans and, like the President's proposal, reduce the dollar limitations on loans to take into account a participant's highest outstanding loan balance during the prior 12 months.

D. Tax Deferral Under Qualified Plans

1. *Limit on contributions and benefits.*—The proposed option would reduce the defined benefit dollar limit on annual benefits from $90,000 to $75,000, and, like the President's proposal, phase the limit in over 10 years of participation. In addition, all employee contributions would be treated as annual additions in applying the defined contribution dollar limit, which would be reduced from $30,000 to $25,000. The present law combined plan limit would be retained, and a 15-percent excise tax would be imposed on aggregate annual distributions in excess of $93,750 (1.25 x $75,000).

2. *Deductions for contributions to qualified plans.*—Like the President's proposal, the proposed option would apply the 25 percent of compensation limit to a combination of a defined benefit and a money purchase pension plan. In addition, the proposed option would retain the 15-percent of aggregate compensation limit (with modifications), repeal defined contribution limit carryforwards for all plans, and impose a 15-percent nondeductible excise tax on nondeductible contributions.

3. *Asset reversions.*—Like the President's proposal, the proposed option would impose a nondeductible excise tax on plan funds reverting to the employer on plan termination. However, the tax would be increased from 10 to 15 percent.

E. Fringe Benefits

1. *Fringe benefit exclusions.*—The proposed option would limit the exclusion for employer-provided health insurance to $120 per month for individual coverage and $300 per month for family coverage. In addition, the option would repeal the exclusions for the cost of up to $50,000 of group-term life insurance coverage and up to $5,000 of death benefits. The proposed option would allow the exclusions for employee educational assistance, group legal services, and van pooling to expire after 1985, as scheduled under present law.

2. *Nondiscrimination requirements.*—The proposed option would provide that a health insurance plan, cafeteria plan, or welfare benefit fund would be considered nondiscriminatory if 90 percent of all employees of an employer are eligible to participate in the plan. A special test would be provided if more than 25 percent of the participants in a plan are highly compensated employees. An exception to the nondiscrimination test would be provided in the case of an employer who, for bona fide business reasons, maintains separate lines of business or operating units.

3. *Cafeteria plans.*—The proposed option would clarify that full-time life insurance salesmen generally would be eligible to participate in a cafeteria plan.

XII. Trusts and Estates; Generation-Skipping Transfer Tax

A. Income of a Minor Child

Under the proposed option, the first $3,000 of unearned income would be taxed to the child at the child's marginal rate. All unearned income in excess of $3,000 would be taxed to the child at the top marginal rate of the parents. In addition, the personal exemption allowed to the child on the child's return would be limited to the lesser of $100 plus earned income, or $1,000. The proposed option would apply the new rules with respect to any child eligible to be claimed as a dependent on the parents' return, regardless of age, and with respect to all unearned income, regardless of whether the assets were transferred from the parents.

B. Income Taxation of Trusts and Estates

Under the proposed option, nongrantor trusts generally would be taxed at the top marginal rate. However, special rules may permit the use of lower rates where the trust's beneficiaries are minor children of the grantor.

In addition, in the case of a qualifying beneficiary trust, income generally would be taxed at the top marginal rate of the beneficiary.

Distributions would not be taxed to the distributee. Thus, the throwback rules and the rules relating to distributable net income would be repealed.

The proposed option generally would apply to trusts created after September 25, 1985.

C. Generation-Skipping Transfer Tax

The proposed option would replace the present generation-skipping transfer tax with a flat-rate tax similar to a separate Treasury Department proposal introduced in the 98th Congress. The revised tax would be imposed at the maximum gift and estate tax rate (i.e., 55 percent through 1987, and 50 percent thereafter). A specific exemption of $1 million per transferor would be provided. The tax would be imposed both on transfers where persons in more than one younger generation share interests and on direct transfers that skip generations.

The proposed option would apply generally to transfers occurring as a result of death after the date of enactment and to inter vivos transfers occurring after September 25, 1985. The present-law tax would be repealed as if never enacted.

XIII. Compliance and Tax Administration

A. Penalties

1. *Penalties relating to information returns.*—The proposed option generally follows the President's proposal in that it would provide a new $5 penalty for incorrect information returns and would consolidate existing penalties relating to information returns. The proposed option also would increase the maximum penalty for not filing information returns from $50,000 to $100,000.

2. *Penalties for failure to pay taxes.*—The proposed option generally follows the President's proposal by increasing the failure to pay penalty to correspond with increased IRS collection costs.

3. *Negligence and fraud penalties.*—The proposed option would apply the negligence and fraud penalties only to the amounts attributable to negligence and fraud (rather than the entire amount of tax due), would modify several aspects of the negligence penalty, would increase the negligence penalty to 10 percent, and would increase the fraud penalty to 75 percent.

4. *Penalty for overstatement of pension liabilities.*—The proposed option would provide a new penalty on actuaries for underpayments of tax due to overstatements of liabilities under a pension plan.

B. Return-Free System

The proposed option would call for a report from the IRS detailing their proposed implementation of the return-free system.

C. Estimated Tax Payments by Individuals

The proposed option would require that individuals increase by 10 percent their payments of estimated taxes (i.e., to at least the lessor of 110 percent (rather than 100 percent) of last year's tax liability or 90 percent (rather than 80 percent) of the current year's tax liability.

D. Interest on Underpayments of Accumulated Earnings Tax

The proposed option would charge interest on underpayments of the accumulated earnings tax from the date the return was originally due to be filed, which is the generally applicable rule.

E. Modification of Employee Withholding Allowance Forms

The proposed option would modify withholding schedules to conform to other tax reform provisions.

F. Awards of Attorneys' Fees in Tax Cases

The proposed option would extend the present-law provision for 4 years, or through December 31, 1989.

G. Exhaustion of Administrative Remedies

The proposed option would require that a taxpayer have his or her case reviewed by the IRS appeals office before being permitted to file the case in the Tax Court and would require an annual report from the Tax Court and the IRS on the backlog.

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