Joint Committee on Taxation
May 12, 1986
JCX-5-86

SUMMARY OF TAX REFORM PROVISIONS IN H.R. 3838

AS ORDERED REPORTED BY THE SENATE COMMITTEE ON FINANCE

CONTENTS

INTRODUCTION

This document[1] provides a brief summary of the principal tax reform provisions in H.R. 3838 as ordered reported, with an amendment in the nature of a substitute, by the Senate Committee on Finance on May 6, 1986. The order and grouping of provisions in this document generally follow the Committee's tax reform markup spreadsheet.

This document is intended to provide a convenient listing, in summary form, of the principal tax reform provisions approved by the Finance Committee, for use of Members of Congress and the public. The official legislative documents on the bill as reported will be the reported bill and the committee report on the bill.

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[1] This document may be cited as follows: Joint Committee on Taxation, Summary of Tax Reform Provisions in H.R. 3838 as Ordered Reported by the Senate Committee on Finance (JCX-5-86), May 12, 1986.

OVERVIEW

The bill approved by the Senate Committee on Finance represents a major restructuring of the Federal income tax system. The bill nearly halves the top individual tax rate to 27 percent and reduces the top corporate tax rate by nearly one-third to 33 percent. The bill is estimated to be revenue neutral; over the next five years, the tax burden of individuals would be reduced by approximately $100 billion, while corporate taxes would increase by a similar amount.

The reduction in tax rates is achieved by broadening the base of the corporate and individual income taxes through the elimination of various tax benefits and preferences allowed under present law. Many of the new provisions increase the tax base of upper-income individuals and allow a reduction in the top tax rate without altering the distribution of the tax burden. These provisions, such as strict new limitations on the use of investment losses to shelter other income and an expanded minimum tax, seek to ensure that high-income taxpayers cannot reduce their effective tax rates to disproportionately low levels.

The bill is intended to simplify the tax system for nearly all Americans. The bill replaces the 15 tax brackets for individuals under present law with two rates--15 percent and 27 percent. Over 80 percent of all taxpayers will have a top rate no higher than 15 percent. Large increases in the standard deduction (the zero bracket amount, under present law) and a near doubling of the personal exemption will eliminate the tax liability of approximately six million low-income individuals. Taxpayers will receive an average tax cut of over six percent in 1988, with low- and middle-income taxpayers experiencing the largest percentage declines in tax liability. The following table shows the estimated average percentage reduction in tax liability by income group.

Income class (thousands of 1986 dollars)	Percentage change in income tax liability 1988
Less than $10	-62.3
$10 - 20	-18.1
20 - 30	-8.0
30 - 40	-5.0
40 - 50	-6.6
50 - 75	-3.9
75 - 100	-3.3
100 - 200	-3.8
$200 and above	-4.7
Total	-6.3

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Other features of the bill for individuals include the retention of the most widely used itemized deductions. Home mortgage interest, State and local income taxes, State and local real and personal property taxes, charitable contributions, medical expenses (above a higher floor), and casualty losses all remain deductible. A $600 additional standard deduction is provided for elderly or blind individuals to replace the extra personal exemption they currently receive. The earned income tax credit for lower income taxpayers is increased, and the child care credit is retained. The capital gains exclusion for individuals is eliminated.

The top corporate income tax rate would be reduced from 46 percent to 33 percent. The investment tax credit is repealed, but the present-law Accelerated Cost Recovery System generally is enhanced for equipment to provide more generous depreciation benefits. One objective of these changes is to improve the allocation of investment within the corporate sector by more nearly equalizing the effective rates of taxation of a wide range of assets. A new alternative minimum tax for corporations would be provided, designed to prevent profitable corporations from avoiding any significant current tax liability.

Summaries of the principal provisions of the bill as ordered reported by the Committee on Finance are provided in the following sections.

SUMMARY OF MAJOR PROVISIONS

I. INDIVIDUAL INCOME TAX PROVISIONS

A. Rate structure

1. There would be two taxable income brackets and tax rates--15 percent and 27 percent. The 27-percent rate would begin at taxable income levels (i.e., adjusted gross income less personal exemptions and less the standard deduction or itemized deductions) of $29,300 for married individuals filing jointly, $23,500 for heads of household, and $17,600 for single individuals.

2. The standard deduction (replacing the zero bracket amount) would be increased to $5,000 for married individuals filing jointly (and for surviving spouses), $4,400 for heads of household, and $3,000 for single individuals.

3. An additional standard deduction of $600 would be allowed for an elderly or blind individual. The present-law credit for elderly individuals and for individuals who are permanently and totally disabled would be retained.

4. The personal exemption would be increased to $2,000 ($1,900 in 1987) for an individual, the individual's spouse, and each dependent.

5. The rate and phase-out levels of the earned income credit would be increased, and adjustments would be made to reflect inflation The child care credit would be retained.

6. The benefit of the 15-percent bracket would be phased out for high-income taxpayers. The phase-out would occur between $75,000 and $145,320 for married individuals filing jointly, between $55,000 and $111,400 for heads of household, and between $45,000 and $87,240 for single individuals.

7. The personal exemption would be phased out between $145,320 and $185,320 for married individuals filing jointly, $111,400 and $151,400 for heads of household, and $87,240 and $127,240 for single individuals.

8. Inflation adjustments ("indexing") to the rate brackets, standard deduction, and personal exemption would be continued, but rounded down to the next lowest multiple of $50.

9. The personal exemption would not be allowed to an individual who is eligible to be claimed as a dependent on another taxpayer's return.

10. The second-earner deduction and income averaging would be repealed.

B. Personal deductions and exclusions

1. Itemized deductions would be retained for State and local income taxes, real estate taxes, and personal property taxes, but disallowed for State and local sales taxes.

2. Itemized deductions would be retained for charitable contributions, casualty losses, medical expenses, and adoption of children with special needs. The floor under the medical expense deduction would be increased from five to ten percent of the taxpayer's adjusted gross income.

3. All allowable itemized deductions would be fully deductible by individuals in both tax brackets; i.e., no itemized deductions would be limited to the lowest bracket.

4. The charitable deduction for nonitemizers would terminate after 1986, as scheduled under present law.

5. The exclusion for scholarships and fellowships would be retained as under present law.

6. The partial exclusion for unemployment compensation benefits would be repealed.

7. The present-law exclusion for certain prizes and awards for charitable, artistic, scientific, and like achievements would apply only where the recipient designates that the prize or award be paid to a tax-exempt charitable organization.

C. Business and investment expenses

1. 80 percent of business meal expenses and business entertainment expenses would be deductible. (Business meals provided as an integral part of certain convention programs would be fully deductible in 1987 and 1988.) Requirements for deducting business meal expenses would be tightened.

2. No deductions would be allowed for costs of attending investment conventions or seminars or for "educational" travel expenses. Deductions for luxury water travel would be limited.

3. The miscellaneous itemized deductions would be repealed. Deductions for certain unreimbursed employee business expenses that under present law may be taken "above-the-line" would be limited to itemizers and would be subject to a floor of one percent of adjusted gross income.

4. Deductions for home office expenses and hobby losses would be limited.

D. Other items

1. The political contributions tax credit would be repealed.

2. The $1/$2 Presidential campaign checkoff would be retained.

II. ACCELERATED COST RECOVERY SYSTEM AND INVESTMENT TAX CREDIT

A. Depreciation

The Accelerated Cost Recovery System ("ACRS") would be retained with the following changes: automobiles, light trucks, and semiconductor manufacturing equipment would be depreciated using the straight-line method over 3 years; research and experimentation property would be placed in the 5-year class until December 31, 1989, and in the 3-year class (using 150-percent declining balance) thereafter; truck tractors would be moved to the 5-year class; property with an ADR midpoint life of 16 years or greater would be moved to the 10-year class; utility property with an ADR midpoint life of 20 years or greater and steam and electric generators or distribution systems would be included in the 15-year class (using 150-percent declining balance); residential real property would be depreciated using the straight-line method over 27-1/2 years; and other real property would be depreciated using the straight-line method over 31-1/2 years. The method of depreciation in the 5-year class and the 10-year class would be increased to 200-percent declining balance, switching to straight-line.

B. Expensing

Taxpayers would be permitted to expense up to $10,000 of the cost of tangible personal property used in a business, subject to a phaseout where the taxpayer's total investment in such property exceeds $200,000 for the year.

C. Investment tax credit

1. The investment tax credit would be repealed, effective January 1, 1986. Transition rules would be provided for certain property placed in service after this date.

2. ITC carryforwards and ITC earned on transition property would be reduced by 30 percent.

D. Finance leases

The finance lease rules would be repealed, effective January 1, 1987 (for property that qualifies for finance lease transition rules under prior tax acts, January 1, 1988).

III. ACCOUNTING PROVISIONS

A. Use of the cash method of accounting would be denied for financial institutions.

B. Use of the installment method would be denied for (1) sales under a revolving credit plan, (2) a portion of sales by dealers in personal or real property (other than those using revolving credit plans), based on the ratio of the taxpayer's outstanding debt to its adjusted asset basis, and (3) sales of publicly traded property. A limited exception would be provided for certain dealer installment sales where resale or rental of the property by the buyer affects the term of the obligation.

For installment sales of certain timeshares and residential lots, the installment method would be allowed in full and excepted from the minimum tax provisions, if the seller elects to pay interest on the deferral of tax attributable to the installment method.

C. Taxpayers would be required to capitalize both direct and indirect inventory, construction, and development costs, including interest, under comprehensive uniform capitalization rules. An exception would be provided for wholesalers and retailers with gross receipts of $5 million or less. In addition, under a transitional rule, present-law rules would apply to excess depreciation on plant and equipment used to produce inventory or self-constructed assets, provided such plant or equipment was placed in service prior to March 1, 1986.

Taxpayers providing property to customers under long-term contracts would be required to capitalize general and administrative costs attributable to cost-plus contracts and certain Federal contracts, in addition to those costs capitalized under the uniform capitalization rules. A special rule would apply for contractors having average annual gross receipts of no more than $10 million with respect to real property construction contracts to be completed within two years.

D. Use of the reserve method of computing deductions for bad debts would no longer be permitted, except for financial institutions, certain farm credit institutions, and certain finance companies.

E. The election to deduct the cost of redeeming "qualified discount coupons" received after the close of the taxable year would be repealed.

F. Solvent taxpayers would be required to recognize currently income from cancellation of indebtedness.

G. The taxable years of all partnerships, S corporations, and personal service corporations would have to be conformed more closely to the taxable years of their owners.

H. Utilities using the accrual method of accounting would be required to include in gross income earned but unbilled income.

I. Depreciation recapture income realized on installment sales of farm irrigation equipment would be taxable under the rules applicable prior to the Deficit Reduction Act of 1984. Thus, recapture income would be recognized as payments are made, rather than in the year of sale.

IV. CAPITAL GAINS

A. The exclusion for long-term capital gains of individuals would be repealed.

B. The present-law rules for nonrecognition of gain on sale of a principal residence where reinvested in a new residence, and for a one-time exclusion of up to $125,000 of gain on sale of a principal residence by a taxpayer age 55 or older, would be retained.

C. The corporate tax rate on long-term capital gains would be 28 percent.

D. The incentive stock option provisions would be liberalized.

E. Under the loss deferral rule in the straddle provisions, the qualified covered call exception would be denied to a taxpayer who fails to hold an option for 30 days after the related stock is disposed of at a loss, where gain on sale of the option is included in the subsequent year.

V. COMPLIANCE AND TAX ADMINISTRATION

A. The penalties for failure to pay taxes, for negligence and fraud, for failure to file information returns, and for substantially understating tax liability would be increased.

B. A one-percent differential between interest rates on refunds and deficiencies would be provided.

C. Information reporting on real estate transactions, Federal contracts, and royalty payments would be required. The requirement that certain information reports be furnished in a separate mailing would be modified. Present law would be retained with respect to information reporting by State and local governments.

D. A user's fee and increased penalties would be imposed on tax shelters.

E. Individuals whose wage withholding does not cover their income tax liability would have to make estimated tax payments equal to 90 percent (rather than 80 percent) of their current-year tax liability.

F. Trusts and estates would be required to make estimated income tax payments, and the four quarterly-payment provision for estates would be repealed. The period of tax deferral for trusts by use of different taxable years would be decreased.

G. Significant increases in the IRS budget for agents, audits, and modernization of compliance systems would be provided. The IRS would be required to institute a program waiving criminal penalties if certain taxpayers voluntarily disclose their tax law violations. A number of areas of tax administration at both the IRS and the Tax Court would be improved.

H. The payment of attorney's fees in tax cases would be modified and extended.

I. The procedures for sharing of tax compliance information between the IRS and State tax authorities would be extended on a trial basis to tax authorities of cities with a population exceeding two million that impose an income tax.

VI. CORPORATE TAX PROVISIONS

A. The top corporate rate would be reduced to 33 percent.

B. The 85-percent dividends received deduction for corporations would be reduced to 80 percent.

C. The $100/$200 dividends exclusion for individuals would be repealed.

D. Amounts paid in connection with a redemption of stock (for example, so-called "greenmail" payments) would not be deductible.

E. The rules limiting use of net operating losses after a change of ownership would be modified.

F. The rules requiring the basis of stock held by a corporation to be reduced by the untaxed portion of extraordinary dividends would be expanded.

G. Basis allocation rules in asset acquisitions would be conformed to rules for stock acquisitions where basis is stepped-up (section 338 rules). Rules for consistent treatment of buyers and sellers would be included.

H. The five-year amortization period for trademarks and tradenames would be repealed. The five-year amortization period for pollution control facilities and the 50-year amortization period for qualified railroad grading and tunnel bores would be retained.

I. The 85-percent limitation on the amount of income tax liability that can be offset by business tax credits would be reduced to 75 percent.

J. Regulated investment companies would be taxed on a calendar-year basis, and the ability of regulated investment companies to pay "spillover dividends" without penalty would be eliminated.

K. Owners of certain bus operating authorities would be allowed an ordinary deduction ratably over five years for loss in value of such authorities.

L. Present law would be retained with respect to (1) the treatment of corporate liquidating sales and distributions (i.e., the "*General Utilities*" rule would not be repealed); (2) the regular tax treatment of merchant marine capital construction funds; and (3) contributions in aid of certain utility construction.

VII. AGRICULTURE, ENERGY, AND NATURAL RESOURCES

Agriculture

A. The present-law rule allowing current deductions for soil and water conservation expenditures would be limited to expenditures consistent with USDA or comparable State conservation plans.

B. The present-law provision allowing current deductions for certain fertilizer expenditures would be retained. The provision allowing current deductions for land clearing expenditures would be repealed.

C. Present-law rules governing capitalization of preproductive period expenditures by farmers would be retained.

D. New restrictions would be imposed on tax benefits available with respect to highly erodible land and wetlands that are converted to crop production.

E. Farmers prepaying more than 50 percent of the costs of feed, seed, and other supplies in any year could not deduct the excess over 50 percent until the year in which the supplies were used or consumed.

F. The rules governing expensing of costs of replanting groves, orchards, or vineyards destroyed by freezing or other natural disasters would be extended to replanting on land other than the land on which the plants were destroyed and to businesses having new owners who materially participate in the business so long as the new owners hold less than a 50-percent interest.

G. Discharge of indebtedness income realized by certain marginally solvent farmers would receive the same tax treatment as if such income were realized by insolvent taxpayers.

Energy and natural resources

A. Business energy tax credits would be extended for solar, geothermal, and ocean thermal energy through 1988, and for wind energy and biomass through 1987, at reduced rates. The residential energy credits would expire (after 1985) as under present law.

B. Alcohol fuels and mixtures would be eligible for the gasoline excise tax exemption at the present-law rate for alcohol fuels mixtures (6 cents per gallon). The income tax credit for alcohol fuels would be repealed.

C. Duty-free treatment would be denied to ethyl alcohol imported from a Caribbean Basin Initiative (CBI) country, unless produced from source material that is the product of a CBI country or the United States.

D. Foreign mining exploration and development costs and intangible drilling costs incurred outside the U.S. would be recovered over a 10-year, straight-line amortization schedule (or electively as part of the basis for cost depletion).

E. Gift and estate tax deductions would be permitted for certain irrevocable charitable donations in perpetuity of real property easements to public charities or governmental entities.

VIII. EMPLOYMENT AND EXCISE TAX PROVISIONS

A. The quarterly payroll threshold at which certain agricultural wages are covered under FUTA would be increased from $20,000 to $40,000.

B. The threshold for accelerated payroll tax deposits would be increased from $3,000 to $5,000.

C. Present law would be retained with respect to excise tax rates and deductibility of excise taxes incurred by businesses.

IX. FINANCIAL INSTITUTIONS

A. The maximum percentage of taxable income that a thrift institution could deduct as an addition to reserves for bad debts would be reduced from 40 percent to 25 percent.

B. Net operating losses of thrift institutions incurred in years ending after 1981 and before 1986 would be eligible to be carried forward eight years.

C. Individuals could elect to deduct losses on deposits in qualified bankrupt or insolvent financial institutions as a casualty loss at the time the loss can be reasonably estimated.

X. FOREIGN TAX PROVISIONS

A. Passive income would be subject to a separate foreign tax credit limitation; income from insurance, shipping, and bona fide active banking generally would not be considered passive or subjected to a separate limitation.

B. Interest that incurs a foreign withholding tax of five percent or more would be subject to a separate foreign tax credit limitation, with a permanent grandfather for certain preexisting loans (and rollovers thereof through 1990) to "Baker 15" country residents, and a 10-year grandfather for certain other preexisting loans.

C. Present-law rules determining the source of income from sales of inventory property generally would be retained.

D. For transportation income (including bareboat charter income), a 50-50 source rule and residence-based reciprocal exemption would be adopted. A four-percent gross withholding tax would be imposed on U.S. source transportation income of foreign persons resident in countries that impose gross tax on transportation income of U.S. persons. U.S. source transportation income of other foreign persons also would be subject to the four-percent tax unless effectively connected with a U.S. business or treated as such pursuant to an election made available to these foreign persons. The four-percent tax would be collected by return. Income earned offshore and in space (other than telecommunications income) generally would be sourced in the recipient's country of residence. Telecommunications income earned offshore or in space would be sourced 50-percent U.S. and 50-percent foreign.

E. The source of amounts paid by 80/20 companies to U.S. and foreign persons would be determined under a look-through rule.

F. In general, the Chairman's proposal on the allocation of interest and other expenses would be adopted, with the following modifications. Interest of a corporation generally would be allocated only among its assets (including assets of any subsidiaries). However, if an upper-tier corporation (e.g., the parent) guarantees the corporation's associated borrowings or otherwise lends its credit, the corporation's borrowings would be treated as made by the upper-tier corporation when necessary to prevent overallocation of interest expense to U.S. source income. Additional rules would be provided to equalize the group's borrowings in the event the upper-tier corporation has borrowings in addition to a subsidiary's borrowings, and to allocate a corporation's interest if the corporation makes its borrowed funds available to related corporations.

G. Certain additional items of passive income earned by controlled foreign corporations would be taxed currently under subpart F. Deferral would be retained for controlled foreign corporations that are engaged in shipping, insurance, or bona fide active banking. The de minimis threshold for exempting foreign base company income from the subpart F current taxation rules would be reduced to five percent of gross income.

H. For section 936 companies, the passive income limitation would be reduced from 35 to 25 percent, and the required cost sharing payment would be increased to 110 percent of the present-law cost sharing payment. Income from investments in financial institutions that are used for certain investments in active business assets in a qualified Caribbean Basin Initiative country or development project in a qualified CBI country would be eligible for U.S. tax exemption. Compliance rules would be provided. In addition, the requirement that funds be received in a possession to qualify for the section 936 credit would not apply to funds received from unrelated parties.

I. The President's proposal for U.S. possessions taxation generally would be adopted; repeal of the Virgin Islands inhabitant rule would apply to all open years. The Virgin Islands would be able to waive or reduce its tax on non-U.S. source income of a V.I. corporation, whether or not that income is V.I.-source income, except to the extent a U.S. person owns an interest (direct or indirect) in that corporation.

J. U.S. investors in passive foreign investment companies would be required to pay an interest charge on repatriation of their deferred income or could elect current taxation of their share of the company's income. Such U.S. investors would be entitled to flow-through treatment of capital gains whether they elect current taxation on their share of income or defer tax.

K. A branch-level tax on profits would be adopted. The present-law withholding tax on U.S. source interest paid by foreign corporations would be modified; the U.S. business income threshold for imposition of the tax would be reduced to 10 percent and the amount of interest subject to withholding would be based on interest expense deducted against U.S. income. The U.S. business income threshold for imposition of the withholding tax on dividends paid by foreign corporations also would be reduced to 10 percent. Treaty-shopping would not be respected.

L. Present-law rules governing the excise tax on insurance and reinsurance premiums paid to foreign insurers would be retained. The Treasury Department would be directed to study the competitive impact on the U.S. reinsurance industry of U.S. tax treaty provisions governing the taxation of foreign reinsurers, and to renegotiate U.S. tax treaties to the extent that the U.S. reinsurance industry is at a significant competitive disadvantage.

M. The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) would be repealed prospectively.

N. Foreign governments would be taxed on business activity, defined to include ownership of controlling interests in U.S. businesses.

O. Importers would be required to take consistent positions on valuation for customs purposes and income tax purposes.

P. Dual resident companies that use deductions here and abroad would not be allowed to consolidate with other U.S. corporations if the dual resident companies consolidate abroad with companies whose earnings are not ever subject to U.S. tax.

Q. The deduction for interest paid to related, tax-exempt parties generally would be denied to the extent that interest exceeds 50 percent of taxable income before this deduction.

R. The President's proposal concerning foreign currency gains and losses generally would be adopted.

S. The present-law deduction for dividends received from a foreign corporation would be modified as follows. The deduction would be allowed (subject to the regular percentage limitations) to 10-percent U.S. corporate shareholders of foreign corporations on a pro rata basis to the extent that the foreign corporation (directly or in certain cases through another foreign corporation) derives income that is effectively connected with a U.S. trade or business, or receives dividends from an 80-percent owned U.S. corporation. Any dividend received by a 10-percent U.S. corporate shareholder of a foreign corporation would be treated as U.S. source to the extent that the dividend is attributable to U.S. source income or effectively connected income.

T. The foreign earned income exclusion would be reduced to $70,000. The exclusion would not be available to U.S. citizens who reside and work in a foreign country in contravention of an executive order.

U. Permanent U.S. resident aliens applying for green card renewal would be required to show that they filed U.S. income tax returns, or were exempt from filing, for the years since their last renewal applications.

V. Civilian U.S. Defense Department employees and Panama Canal Commission employees in Panama would be permitted to exclude allowances equivalent to those that may be excluded by State Department employees in Panama. U.S. taxation of U.S. persons would not be prevented by a treaty with Panama.

W. Present law governing Foreign Sales Corporations (FSCs) would be retained.

XI. INSURANCE PRODUCTS AND COMPANIES

A. Life insurance products and companies

1. Present-law treatment of inside buildup and policyholder loans with respect to life insurance contracts would be retained.

2. A structured settlement company would be taxed on the investment income on contracts purchased to fund a structured settlement agreement.

3. The special 20-percent life insurance company deduction would be repealed.

4. The small life insurance company deduction would be retained.

B. Property and casualty insurance companies

1. Twenty percent of the annual increase in unearned premiums would be included in income, as would 20 percent of the outstanding balance of the unearned premium reserve ratably over 7-1/2 years. In the case of bond insurance, 10 percent (rather than 20 percent) of the annual increase in unearned premiums and the outstanding balance of the unearned premium reserve would be included in income.

2. A pretax discounting rule for loss reserves, applicable to each line of business (including unpaid loss reserves attributable to accident and health insurance lines of business of any insurers that are not subject to life insurance discounting rules) would be adopted at a discount rate initially set at five percent and phased in to a rolling average of 75 percent of the applicable Federal rate. For title insurers, the discounting rule, rather than the unearned premium reserve rule, would apply to loss reserves.

3. The protection against loss account would be repealed.

4. A single small company provision would be adopted.

XII. INTEREST EXPENSE

A. No deduction would be allowed for consumer interest (such as interest on car loans or credit card balances), or for investment interest expense in excess of investment income. The definitions of investment interest and investment income would be modified.

The effect of this rule would be phased in, so that 35 percent of such interest would be disallowed in 1987, 60 percent in 1988, 80 percent in 1989, and 90 percent in 1990; 100 percent disallowance would begin in 1991. Interest on the principal residence and a second residence of the taxpayer would remain fully deductible.

B. Interest on loans to fund an IRA would not be deductible.

XIII. MINIMUM TAX

A. An alternative minimum tax would be imposed on individuals and corporations at a 20-percent rate.

B. The following items would be treated as preferences: accelerated depreciation on real and personal property, intangible drilling costs (in excess of net oil and gas income), rapid amortization for pollution control facilities, circulation expenditures of individuals and personal holding companies, research and experimentation expenditures of individuals, percentage depletion, incentive stock options, the completed contract and other methods of accounting for long-term contracts, the installment method of accounting when used by dealers, net losses on passive farming activities, excess bad debt reserves of financial institutions, mining exploration and development costs of individuals and personal holding companies, and capital construction funds of shipping companies. In addition, one-half of reported profits of a corporation not otherwise included in the minimum tax base would be a preference.

C. Limitations on nonparticipatory business losses, similar to those under the regular tax, would apply in calculating alternative minimum taxable income of individuals, personal holding companies, and personal service corporations, and would be fully effective in 1987.

D. Credits other than the foreign tax credit would not be allowed against the minimum tax. The foreign tax credit could not offset more than 90 percent of minimum tax liability.

XIV. PENSIONS AND EMPLOYEE BENEFITS; ESOPs

Pensions

A. The deduction for IRA contributions would be limited to individuals not covered by a tax-favored retirement plan. Other individuals could make nondeductible contributions to an IRA within present-law limitations ($2,000/$2,250 annually). Earnings on amounts allowed to be contributed to an IRA, whether or not the contribution is deductible, would be tax-exempt (until withdrawn).

B. Annual elective deferrals of an employee under all cash or deferred arrangements (sec. 401(k) plans) would be limited to $7,000. An additional $2,500 of elective deferrals would be permitted under a section 401(k) plan if the $2,500 is invested in an ESOP.

C. The special nondiscrimination tests applicable to section 401(k) plans would be modified by redefining the group of highly compensated employees. The modified test also would be applied to all employer matching and after-tax employee contributions.

D. Tax-exempt employers would be permitted to maintain section 401(k) plans. State and local governments would not be permitted to establish section 401(k) plans, but section 401(k) plans adopted by State and local governments before March 1, 1986 would be grandfathered.

E. Simplified employee plans (SEPs) maintained by small employers could, under certain circumstances, include a cash or deferred arrangement.

F. Coverage tests, the rules governing the integration of qualified plan benefits with social security, and the vesting requirements applicable to qualified plans would be modified and strengthened. In general, a participant would be required to be fully vested in employer-funded benefits after five years of service.

G. A 15-percent additional income tax would be imposed on withdrawals from a qualified plan or an IRA before death, disability, or attainment of age 59-1/2, unless the payments are made in the form of a life annuity or substantially level distributions over the individual's life. Exceptions would be provided in the case of certain unforeseen hardships, early retirement on or after age 55, and distributions to participants from ESOPs. The tax would be lowered to 10 percent in the case of withdrawals of employer matching contributions and earnings attributable to after-tax contributions, and to five percent in the case of withdrawals under nonqualified deferred annuities.

H. Ten-year forward income averaging generally would be replaced with five-year averaging available under limited circumstances. Ten-year averaging (at present-law tax rates) would remain available to certain individuals.

I. For purposes of the dollar limit on benefits under defined benefit plans and for purposes of determining an employer's deduction for plan contributions, normal retirement age would be the social security retirement age (scheduled to increase from 65 to 67 between the years 2000 and 2022). An actuarial reduction of the limit would be made for benefits commencing before the social security retirement age. The $75,000 safe harbor for benefits commencing on or after age 55 would be eliminated.

J. The dollar limits on contributions to and benefits from defined contribution and defined benefit plans, respectively, would be indexed by reference to percentage increases in the social security wage base. Indexing of the dollar limit on annual additions to a defined contribution plan would be delayed until the present-law dollar limit ($30,000) is no more than 25 percent of the dollar limit for defined benefit plans.

K. A 10-percent nondeductible excise tax would be imposed on reversions of surplus assets from terminated plans, with an exception for surplus assets transferred from a terminated plan to an ESOP.

L. The three-year basis recovery rule would be phased out beginning after 1987. For individuals whose annuity starting date is after January 1, 1988, 50 percent of basis would be recovered under the three-year basis recovery rule and the remainder would be recovered ratably over the period of the annuity. For individuals whose annuity starting date is after January 1, 1989, the three-year basis recovery rule would be repealed, and 100 percent of basis would be recovered ratably over the period of the annuity.

M. Present law generally would be retained with respect to section 403(b) annuities.

<u>Employee benefits</u>

A. The statutory exclusions for employer-provided educational assistance and group legal services would be reinstated on a permanent basis, with a cap on the educational assistance exclusion. The statutory exclusions for employer-provided health insurance, $50,000 of group term life insurance, $5,000 of death benefits, and employer-provided dependent care assistance would be retained. An exclusion would be provided for qualified campus lodging furnished by educational institutions to employees.

B. All employee awards (e.g., for productivity) would be includible in income, except that awards of tangible personal property for length of service or safety achievement would be excludable, subject to certain limitations, for up to $400 ($1,600 if made under a qualified plan where the average award does not exceed $400).

C. Self-employed individuals would be allowed to deduct (for income tax purposes) 50 percent of the health insurance coverage under a nondiscriminatory employer-provided health plan.

- D. Nondiscrimination rules applicable to employer-provided employee benefits would be modified by (1) applying nondiscrimination rules to insured health plans; (2) revising the rules for self-insured medical reimbursement plans and group-term life insurance; (3) establishing a uniform definition of highly compensated employees and excludable employees; (4) providing an alternative test for flexible benefit plans (including cafeteria plans); and (5) requiring reasonable notice of benefit plan eligibility to employees.

E. The treatment of accrued vacation pay and the funding restrictions applicable to retiree medical benefits would be modified.

ESOPs

A. The payroll-based tax credit for ESOPs would be repealed, effective for compensation paid after 1986.

B. The deduction for dividends paid on ESOP stock would be extended to apply to dividends used to repay ESOP loans.

C. An exclusion from the gross estate of a decedent would be provided for 50 percent of the proceeds realized on the sale (by the executor) of stock in the estate to an ESOP.

D. The 50-percent interest exclusion for ESOP loans would be extended (1) to loans made by mutual funds, and (2) in the case of a loan to an employer that is matched by contributions of stock to an ESOP.

E. The ESOP put option requirements would be applied to all stock bonus plans.

F. The definition of highly compensated employees for purposes of the special limit on contributions applicable to ESOPs would be conformed to the new definition of highly compensated employees applicable to qualified plans.

G. Distributions to plan participants would be permitted on account of the termination of an ESOP without regard to the period that employer securities have been held by the plan.

H. The period after which distributions may be made under an ESOP would be shortened and the put option requirements would be modified.

I. The provision permitting the rollover of gain in the case of stock sold to an ESOP would apply if the ESOP holds at least 30 percent of the total number of shares of each class of stock of the employer.

XV. RESEARCH AND DEVELOPMENT PROVISIONS

A. The R&D credit would be extended for four years (through 1989) at the present 25-percent rate, with modifications to the credit definition of research and with increased incentives for university basic research.

B. A two-year rule would be adopted allowing the allocation of 75 percent of U.S.-incurred research expenditures against U.S. income.

C. An exception from the personal holding company rules would be provided for certain companies actively engaged in the business of developing computer software.

XVI. TAX SHELTERS AND REAL ESTATE

Rule limiting use of certain losses

Losses and credits from a business activity in which the taxpayer does not materially participate (e.g., a limited partner's interest in a limited partnership) would not be allowed against other income, including salary, active business income, and portfolio income (such as dividends, interest, royalties, and nonbusiness capital gains, and including portfolio income passed through to the taxpayer from a nonparticipatory activity). Losses and credits from nonparticipatory business activities that are not allowed could be carried forward indefinitely and would be allowed in subsequent years against income from nonparticipatory activities. Disallowed losses from a nonparticipatory activity would be allowed in full when the taxpayer recognizes gain or loss upon a disposition of his or her entire interest in the activity.

The effect of the rule would be phased in, so that 35 percent of excess nonparticipatory losses and credits would be disallowed in 1987, 60 percent in 1988, 80 percent in 1989, and 90 percent in 1990; 100 percent disallowance would begin in 1991.

Under the nonparticipatory loss limitation rule, working interests in oil and gas properties with respect to which the taxpayer's liability is not limited (that is, working interests other than those owned, e.g., through limited partnership interests) would be treated as active business interests even if the taxpayer does not materially participate in the activity. Rental activities would be treated as nonparticipatory business activities even if the taxpayer does materially participate. Taxpayers who materially participate in rental real estate activities would be permitted to use losses and credits from such activities against up to $25,000 of other income. Low-income housing credits could be so used whether or not the taxpayer materially participated. The $25,000 amount would be phased out between $100,000 and $150,000 of income.

<u>Real estate</u>

A. At-risk rules would be extended to real estate, with an exception for third-party nonrecourse debt and for certain loans made by equity participants.

B. A 20-percent rehabilitation credit would apply for certified historic structures; a 10-percent credit would be available for other qualified rehabilitation expenditures for buildings placed in service before 1936.

C. For low-income rental housing, a new tax credit would be provided as an elective alternative to tax-exempt bonds and Federal subsidies. At least 20 percent of the housing units in projects qualifying for the credit would have to be occupied by tenants having incomes of 50 percent or less of the area median income. An annual eight-percent credit, available for 10 years, would be provided for low-income units occupied by tenants with incomes of 50 percent or less of the area median income. In addition, for a limited number of units occupied by individuals with incomes between 50 percent and 70 percent of median income, an annual four-percent credit would be provided for 10 years. Preferential depreciation and amortization provisions would be repealed.

D. The rules relating to taxation of real estate investment trusts would be modified.

E. Rules would be provided for the treatment of certain mortgage-backed securities.

XVII. TAX-EXEMPT BONDS

A. Tax-exempt bonds would be continued for direct funding of government operations and for certain other activities under rules similar to present law.

B. Tax-exempt financing would be continued for activities of section 501(c)(3) organizations that are directly related to their exempt purpose.

C. Tax-exempt IDB financing would be allowed for--

(1) Multifamily rental housing,

(2) Airports and docks and wharves,

(3) Sewage, solid waste disposal, and water facilities,

(4) Electric and gas local furnishing systems,

(5) Local district heating and cooling systems,

(6) Hazardous waste disposal facilities, and

(7) Small-issue IDBs (subject to present-law sunset dates) and qualified redevelopment IDBs.

D. Bonds would be IDBs if--

(1) 25 percent or more of bond proceeds were used in a trade or business and direct or indirect payments with respect to the financed property were made to the issuer by a private party.

(2) Liberalized management contract rules would be provided for determining when bond proceeds are used in a private trade or business.

E. Tax-exemption would be continued for qualified student loan bonds and extended to student loan bonds issued under State programs not benefiting from Federal guarantees.

F. Mortgage revenue bonds would be continued under present-law rules, along with the MCC alternative (with an increased trade-in rate); the present-law sunset date for qualified mortgage bonds would be retained.

G. Present-law volume caps would be retained, including the scheduled reduction to $100 per capita in the volume cap for student loan bonds and most IDBs. The following bonds would not be subject to volume caps--

(1) Section 501(c)(3) organization bonds,

(2) IDBs for certain governmentally owned airports, docks and wharves, and sewage, solid waste disposal, and water facilities, and

(3) Multifamily rental housing IDBs.

H. The arbitrage rules for all tax-exempt bonds would be modified in several respects, including--

(1) Rebate rules like the present-law IDB rules would be extended to arbitrage earned on tax-exempt bonds other than--

(a) Arbitrage profits on all mortgage revenue bonds, which would be subject to rebate requirements that currently apply to qualified mortgage bonds, and

(b) Certain arbitrage profits on student loan bonds issued in conjunction with the Federal GSL and PLUS programs.

(2) Advance refundings would be limited to governmental bonds and section 501(c)(3) organization bonds, and would be subject to new restrictions.

(3) For all tax-exempt bonds, yield would be computed using the original issue discount rules of the Code (i.e., the <u>State of Washington</u> case would be reversed).

(4) Tax-exemption would be denied for pension arbitrage bonds.

(5) Certain other arbitrage rules currently applicable to IDBs would be extended to all tax-exempt bonds.

I. All tax-exempt bond-financed property would be depreciated using the straight-line method. Generally, such property would be depreciated over the ADR midpoint life or 40 years for real property. Multifamily housing would be depreciated over 27-1/2 years and solid waste disposal facilities and hazardous waste facilities would be depreciated over eight years.

J. Miscellaneous other amendments would be made, including--

(1) The rules on small-issue IDBs for first-time farmers would be liberalized and these bonds would be treated as small-issue IDBs for manufacturing facilities.

(2) The aggregate amount of depreciable farm property permitted to be financed for any principal user would be $250,000.

(3) Limited equity cooperatives would be permitted to elect to satisfy the targeting rules for multifamily rental housing in lieu of the qualified mortgage bond targeting rules, but bonds for electing cooperatives would be subject to the qualified mortgage bond volume cap and tenant/shareholders in such cooperatives would be treated as renters for purposes of individual itemized deductions.

(4) Information reporting requirements for issuers would be extended to all tax-exempt bonds.

XVIII. TAXATION OF TRUSTS, ESTATES, AND MINOR CHILDREN; ESTATE, GIFT, AND GENERATION-SKIPPING TAXES

A. The unearned income of a child under 14 would be taxed to the child at the top marginal rate of the parents to the extent attributable to property received from the parents. Unearned income that is derived from assets received from other sources (or by reason of a parent's death) and that is placed in a qualified segregated account would be taxed at the child's marginal rate, as would earned income of the child.

B. The income of a trust generally would be taxed to its grantor if the trust corpus will revert to the grantor or the grantor's spouse.

C. The rate schedule applicable to the retained income of trusts and estates would be compressed as compared with the rates applicable to individuals.

D. The generation-skipping transfer tax would be retained without change from present law.

E. The period during which heirs (of individuals dying before 1982 leaving property for which estate tax special use valuation was elected) must continue to own and use such property without incurring a special recapture tax would be reduced from 15 years to 10 years.

F. Where an executor of a decedent's estate has elected special use valuation on a timely filed estate tax return by providing substantially all the information elicited by the return form, the executor would have an additional 90 days, after being notified by the IRS, to supply any missing information.

G. Certain disclaimers executed before February 22, 1982, with respect to property interests created before November 15, 1958, would be treated as qualified disclaimers for gift tax purposes.

XIX. MISCELLANEOUS PROVISIONS

A. The targeted jobs credit would be extended for three years, with modifications. The present rate would apply for first-year employment. No credit would be available for second-year employment or for individuals who work for the employer for less than a specified period.

B. Expired provisions for (1) expensing costs of removing barriers to the handicapped and (2) spouses of Vietnam MIA's would be extended.

C. An exemption from the unrelated business income tax would apply for income of certain tax-exempt organizations from exchanges and rentals of membership lists.

D. The requirements for tax exemption as a title-holding company would be modified.

E. Private foundations could retain "grandfathered" business holdings acquired prior to May 27, 1969, if certain requirements are met.

F. Tenant-stockholders in cooperative housing corporations would not be limited to individuals for purposes of certain deduction rules.

XX. TECHNICAL CORRECTIONS

Technical corrections would be made to provisions of the Deficit Reduction Act of 1984, the Retirement Equity Act of 1984, and other recently enacted tax legislation.