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General Explanations of the President's Budget Proposals Affecting Receipts



**Department of the Treasury
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TREASURY DEPARTMENT

CAPITAL GAINS TAX RATE REDUCTION FOR INDIVIDUALS

The Budget again includes a reduction of the capital gains tax rate for individuals on long-term investments. The Budget provides for a 10, 20, or 30 percent exclusion for long-term capital gains on assets held by individual taxpayers for one, two or three years, respectively. The three-year holding period requirement will be phased in over three years.

In his State of the Union Address on January 29, 1991 the President asked Congressional leaders to cooperate with the Administration in a study led by Federal Reserve Chairman Alan Greenspan to sort out technical differences over the distributional and economic impacts of a capital gains reduction.

A reduction in capital gains taxes should benefit all Americans by providing incentives for saving and investment that would result in higher national output and more jobs.

Current Law

Under current law, the full amount of capital gains income is generally taxable but the rate on such gains is capped at 28 percent. Capital gains are generally subject to 15 percent or 28 percent statutory tax rates. When capital gains taxes interact with other provisions in the income tax code, however, the actual tax cost of an asset sale can be significantly higher. Interacting provisions include the requirement that itemized deductions for medical and miscellaneous expenses exceed a percentage of adjusted gross income, the phase-outs with increasing income of IRA deductions, passive activity loss limitations, and the phase-out of personal exemptions and the three percent floor on itemized deductions enacted in 1990.

While the Tax Reform Act of 1986 eliminated the capital gains exclusion of prior law, it did not eliminate the legal distinction between capital gains and ordinary income, or between short-term and long-term capital gains. These distinctions currently serve to identify those transactions eligible for the 28 percent maximum rate and subject to the limitations on deduction of capital losses. Capital assets effectively include all property except inventories or other items held for sale in the ordinary course of business and certain other listed assets. Examples of capital assets include corporate stock, a home, a farm or business, real estate, and antiques. Gains or losses from the sale or exchange of capital assets held for one year or longer are classified as long-term capital gains or losses.

Individuals with capital losses exceeding capital gains may generally deduct up to \$3,000 of such losses against ordinary income. A net capital loss in excess of the deduction limitation may be carried forward. Special rules allow individuals to treat losses of up to \$50,000 (\$100,000 on a joint return) with respect to stock in certain small business corporations as ordinary losses.

Depreciation recapture rules recharacterize a portion of capital gains on depreciable property as ordinary income. These rules vary for different types of depreciable property. For personal property, all previously allowed depreciation not in excess of the realized capital gain is generally recaptured as ordinary income. For real property using straight-line depreciation, there is no depreciation recapture if the asset is held at least one year. For real property acquired before 1987, generally only the excess of the depreciation claimed in excess of straight-line depreciation is recaptured as ordinary income. There are also recapture rules applicable to the disposition of depletable property and to certain other assets.

Capital gains and losses are generally taken into account when "realized" upon the sale, exchange, or other disposition of the asset. Certain dispositions of capital assets, such as transfers by gift, are not generally realization events for income tax purposes. In general, in the case of gifts the donor does not realize gain or loss, and the donor's basis in the property carries over to the donee. In certain cases, such as the gift of a bond with accrued market discount or of property that is subject to indebtedness in excess of the donor's basis, the donor may recognize ordinary income upon making a gift. The capital gain in a charitable contribution of appreciated property (other than tangible personal property donated in 1991) is included as a preference item in calculating the alternative minimum tax. Gain or loss is not realized on a transfer at death, and the beneficiary's basis in the inherited asset is generally the fair market value of the asset at (or near) the date of death.

Reasons for Change

Restoring a capital gains tax rate differential is important to restore economic growth and competitive strength by promoting savings, entrepreneurial activity, and risky investment in new products, processes, and industries. At the same time, investors should be encouraged to extend their horizons and search for investments with longer-term growth potential. The future competitiveness of this country requires a sustained flow of capital to innovative, technologically advanced activities that may generate minimal short-term earnings but promise strong future profitability. A preferential tax rate limited to longer-term commitments of capital will encourage business investment patterns that favor innovation and long-term growth over short-term profitability. The resulting increase in national output will benefit all Americans by providing jobs and raising living standards. In addition to the improvements in productivity and economic growth, a lower rate on long-term capital gains will also improve the fairness of the individual income tax by providing a rough adjustment for the taxation of inflationary gains that do not represent any increase in real income.

Incentives for Longer-Range Investment. A capital gains preference has long been recognized as an important incentive for capital investment. The first tax rate differential for capital gains in this country was introduced by the Revenue Act of 1921. For the next 65 years there was always some tax rate differential for long-term capital gains. The preferential treatment for capital gains has taken various forms, including an exclusion of a fixed portion of the nominal gains, an exclusion that depended on the length of time a

taxpayer held an asset, and a special maximum tax rate for capital gains. But at no time between 1921 and 1987 were long-term capital gains ever taxed at the same rates as ordinary income. In 1990, Congress set the maximum marginal tax rate on capital gains at 28 percent, or three percentage points below the maximum marginal rate on ordinary income. Nevertheless, as shown in Figure 1, the average effective tax rate on realized capital gains is currently substantially higher than it has been in the past.

By eliminating the capital gains exclusion and lowering tax rates on ordinary income, the 1986 Act increased the incentives for short-term trading of capital assets. This occurred because the tax rate on long-term capital gains was increased while the tax rate on short-term capital gains was reduced. By providing for a sliding scale exclusion that provides full benefits only for investments held at least three years after a phase-in period, the Budget proposal would increase the incentive for longer term investing.

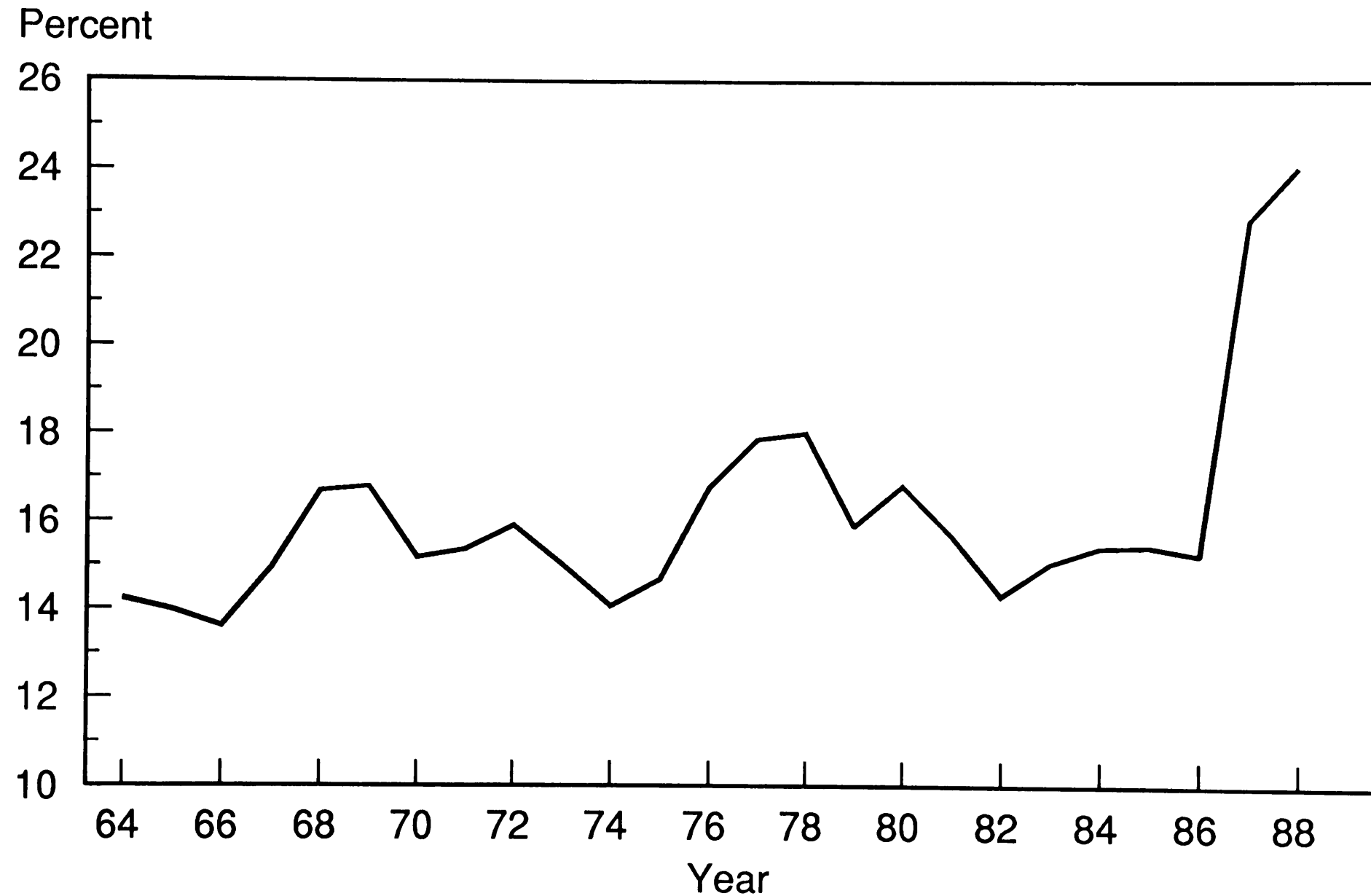
The Cost of Capital and International Competitiveness. The capital gains tax is an important component of the cost of capital, which measures the pre-tax rate of return required to induce businesses to undertake new investment. Evidence suggests that the cost of capital in the United States is higher than in many other industrial nations. While not solely responsible for the higher cost of capital, high capital gains tax rates hurt the ability of U.S. firms to obtain the capital needed to remain competitive. By reducing the cost of capital, a reduction in the capital gains tax rate would stimulate productive investment and create new jobs and growth.

Our major trading partners already recognize the economic importance of low tax rates on capital gains. Virtually all other major industrial nations provide much lower tax rates on capital gains or do not tax capital gains at all. Canada, France, Germany, Japan, the Netherlands, and the United Kingdom, among others, all treat capital gains preferentially.

The Lock-In Effect. Under a tax system in which capital gains are not taxed until realized by the taxpayer, a substantial tax on capital gains tends to lock taxpayers into their existing investments. Many taxpayers who would otherwise prefer to sell their assets to acquire new and better investments may instead continue to hold onto the assets rather than pay the current high capital gains tax on their accrued gains.

This lock-in effect of capital gains taxation has three adverse effects. First, it produces a misallocation of the nation's capital stock and entrepreneurial talent because it distorts the investment decisions that would be made in the absence of the capital gains tax. For example, the lock-in effect reduces the ability of entrepreneurs to withdraw from an enterprise and use the funds to start new ventures. Productivity in the economy suffers because entrepreneurs are less likely to move capital to where it can be most productive, and because capital may be used in a less productive fashion than if it were transferred to other, more efficient, enterprises. These effects can be especially critical for smaller firms which may not have good access to capital markets and where ownership and operation frequently go together. Second, the lock-in effect produces distortions in the investment portfolios of individual taxpayers. For example, some individual investors may be induced to

FIGURE 1.
AVERAGE EFFECTIVE TAX RATE ON CAPITAL GAINS
1964-1988



Department of the Treasury
Office of Tax Analysis
January 1991

assume more risk or hold a different mix of assets than they desire because they are reluctant to sell appreciated investments to diversify their portfolios. Third, the lock-in effect reduces government receipts. To the extent that taxpayers defer sales of existing investments, or hold onto investments until death, taxes that might otherwise have been paid are deferred or avoided altogether. Therefore, individual investors, the government, and other taxpayers lose from the lock-in effect. The investor is discouraged from pursuing more attractive investments and the government loses revenue.

Substantial evidence from more than a dozen studies demonstrates that high capital gains tax rates in previous years produced significant lock-in effects. The importance of the lock-in effect may also be demonstrated by the fact that realized capital gains were 16 percent lower under the high tax rates in 1987 than under the lower rates in 1985, even though stock prices had risen by approximately 50 percent over this period. The high tax rates on capital gains under current law imply that the lock-in effect is greater than at any prior time.

Penalty on High-Risk Investments. Full taxation of capital gains, in combination with limited deductibility of capital losses, discourages risk taking. It therefore impedes investment in emerging high-technology and other high-risk firms. While many investors are willing to take risks in anticipation of an adequate return, fewer are willing to contribute "venture capital" if a significant fraction of the increased reward will be used merely to satisfy higher tax liabilities. A tax system that imposes a high tax rate on gains from the investment reduces the attractiveness of risky investments, and may result in many worthwhile projects not being undertaken.

In particular, it is inherently more risky to start new firms and invest in new products and processes than to make incremental investments in existing firms and products. It is therefore the most dynamic and innovative firms and entrepreneurs that are the most disadvantaged by high capital gain tax rates that penalize risk taking. Such firms have traditionally been contributors to America's edge in international competition and have provided an important source of new jobs.

Double Tax on Corporate Stock Investment. Under the U.S. income tax system, income earned on investments in corporate stock is generally subjected to two layers of tax. Income on corporate investments is taxed first at the corporate level at a rate of 34 percent. Corporate income is taxed a second time at the individual level in the form of taxes on capital gains and dividends at rates ranging from 15 to 31 percent. The combination of corporate and individual income taxes thus can produce effective tax rates that are substantially greater than individual income tax rates alone. To the extent the return to the investor is obtained through appreciation in the value of the stock (rather than through dividend income), a reduction in capital gains tax rates provides a form of relief from this double taxation of corporate income. While a lower capital gains tax rate reduces the cost of capital for both corporate and noncorporate business, the greater liquidity of shares in publicly-traded companies suggests that the overall effect would be to reduce the bias towards noncorporate business that results from our dual-level tax system.

Description of Proposal

General Rule. The capital gains tax rate would be reduced by means of a sliding-scale exclusion. Individuals would be allowed to exclude a percentage of the capital gain realized upon the disposition of qualified capital assets, and would apply their current marginal rate on capital gains (either 15 or 28 percent) to the reduced amount of taxable gain. The amount of the exclusion would depend on the holding period of the assets. Assets held three years or more would qualify for an exclusion of 30 percent. Assets held at least two years but less than three years would qualify for a 20 percent exclusion. Assets held at least one year but less than two years would qualify for a 10 percent exclusion. For example, individuals subject to a 28 percent tax on capital gain (*i.e.*, taxpayers in the 28 and 31 percent tax brackets for ordinary income) would pay rates of 25.2, 22.4, and 19.6 percent for assets held one, two, or three years, respectively. The corresponding figures for individuals subject to a 15 percent rate would be 13.5, 12.0, and 10.5 percent.

Qualified assets would generally be defined as any assets qualifying as capital assets under current law and satisfying the holding period requirements, except for collectibles. Collectibles are assets such as works of art, antiques, precious metals, gems, alcoholic beverages, and stamps and coins. Assets eligible for the exclusion would include, for example, corporate stock, manufacturing and farm equipment, a home, an apartment building, a stand of timber, or a family farm.

Phase-in Rules and Effective Dates. The proposal would be effective generally for dispositions of qualified assets after the date of enactment. For the balance of 1991, the full 30 percent exclusion would apply to assets held at least one year. For dispositions of assets in 1992, assets would be required to have been held for two years or more to be eligible for the 30 percent exclusion, and at least one year but less than two years to be eligible for the 20 percent exclusion. For dispositions of assets in 1993 and thereafter, assets would be required to have been held at least three years to be eligible for the 30 percent exclusion, at least two years but less than three years for the 20 percent exclusion and at least one year but less than two years for the 10 percent exclusion.

Additional Provisions. In order to prevent taxpayers from benefitting from the exclusion provision for depreciation deductions that have already been claimed in prior years, the depreciation recapture rules would be expanded to recapture all prior depreciation deductions. All taxpayers would be able to benefit from the proposed exclusion to the extent that a depreciable asset has increased in value above its unadjusted basis. The excluded portion of capital gains would be added back when calculating income under the alternative minimum tax, however, the special rule relating to contributions of tangible personal property in 1991 would not be modified. Installment sale payments received after the effective date will be eligible for the exclusion without regard to the date the sale actually took place. For purposes of the investment interest limitation, only the net capital gain after subtracting the excluded amount would be included in investment income. The 28 percent limitation on capital gains not eligible for the exclusions would be retained.

Examples of the Effects of Proposal

Example A. Taxpayer A is a single individual earning \$16,000 whose mutual fund investments have a reported long-term capital gain of \$500 in late 1991.

Under current law, her tax on the \$500 capital gain would be 15 percent of the full \$500 gain, or \$75.

Under the proposal, her tax would be reduced to \$52.50, which is 15 percent of \$350 (\$500 less the 30 percent exclusion).

Example B. Example B is a two-earner couple with combined taxable income other than capital gains of \$40,000. In 1993, they sell corporate stock realizing a \$1,500 capital gain on stock held 15 months and a \$2,500 capital gain on stock held 5 years.

Under current law both gains would be subject to taxation at a tax rate of 28 percent. Tax on the \$1,500 gain would be \$420, and tax on the \$2,500 gain would be \$700, for a combined tax of \$1,120.

Under the proposal, the gain from the sale of stock held 15 months would be eligible for a 10 percent exclusion and the gain on the stock held 5 years would be eligible for a 30 percent exclusion. The tax on the stock held 15 months would be \$378 and the tax on the stock held 5 years would be \$490, for a combined tax of \$868, which would be 22 percent lower than their liability under current law.

Example C. Taxpayer C is the founder of a five year old computer software company who would like to sell the company in order to start a new company making a new product. Taxpayer C has a salary of \$380,000 and \$20,000 in dividend and interest income. Taxpayer C sells the stock in the computer software company for \$2 million, resulting in a capital gain of \$1.8 million after deduction of his \$200,000 cost basis.

Under current law, Taxpayer C would pay a capital gains tax of about \$523,840 (depending on the level and composition of his itemized deductions), leaving him with net proceeds of \$1,476,160 from the sale of the company.

Under the proposal, the capital gains tax, including the alternative minimum tax, would be about \$427,915 (again, depending on the level and composition of his itemized deductions). The net proceeds from selling the company would now be about \$1,572,085. Thus, Taxpayer C would have about \$95,925 of additional funds that could be invested in the new business.

Revenue Estimates

Capital gains realizations are highly responsive to changes in stock prices and general economic conditions as well as to capital gains tax rates. Furthermore, taxpayers may adjust their purchases and sales of capital assets and their other income sources and deductions in response to new tax rules. Since 1978, Treasury revenue estimates of capital gains have taken into account expected changes in taxpayer behavior.

These behavioral effects are the subject of continued empirical research. Treasury's Office of Tax Analysis (OTA) incorporates all effects believed to be important and presents its best estimate of the expected effects. The proposal is expected to increase Treasury receipts as compared to current law receipts due to increased realizations. The revenue estimates noted below assume a February 15, 1991 effective date. The increase in revenues is expected to be greatest in fiscal year 1992, due to the unlocking of existing capital gains, and smaller thereafter. The expected changes in revenues are modest in comparison to the magnitude of the expected total amount of revenues from the capital gains tax (in excess of \$40 billion per year).

Details of Revenue Estimates

The details of the revenue estimates are shown in Table 1. Line I of Table 1 shows the revenue loss that results from a flat 30 percent exclusion on the amount of capital gains that would be realized at current law tax rates; *i.e.*, "baseline" realizations that would have occurred without a change in tax rates. This loss is what a "static" revenue estimate for a 30 percent exclusion would show. This "static" revenue loss is estimated to be \$11.3 billion in fiscal year 1992, gradually increasing to about \$18 billion by 1996.

Line II of Table 1 shows the estimated revenue from additional realizations that would be induced by a flat 30 percent exclusion. These induced gains arise from several sources. They represent realizations accelerated from future years, realizations due to portfolio shifting, or realizations that would otherwise have been tax-exempt because they would have been held until death, donated to charity, or not reported. As indicated by a comparison of line I and II, revenues from induced realizations are estimated to be sufficient to offset the static revenue loss on current gains for several years, but not in the long run. This conclusion is based on Treasury's analysis of the findings of numerous statistical studies of the responsiveness of capital gains to lower tax rates, and is consistent with the revenue experience of previous capital gains tax rate changes.

Line III shows the revenue effects of limiting the exclusion to 20 percent for assets held two years and 10 percent for assets held one year, and the phase-in of these holding period limitations. The estimates reflect a reduction in static revenue losses, the effects of induced realizations, and the effects of deferring realizations of assets not yet qualifying for the full 30 percent exclusion. These provisions, which are aimed at promoting a longer-term investment horizon, produce revenue gains in the long run, although a small net revenue loss over the budget period.

TABLE 1

REVENUE EFFECTS OF THE PRESIDENT'S CAPITAL GAINS PROPOSAL

Item	Fiscal Year (\$ Billions)						1991-96
	1991	1992	1993	1994	1995	1996	
I. Static effect of 30% exclusion	-1.7	-11.3	-13.0	-14.6	-16.2	-18.0	-74.7
II. Effect of taxpayer behavior 1/	2.3	14.9	15.1	14.7	15.1	16.3	78.3
III. Effect of the 3-year holding period	0.0	-0.1	-0.8	-0.8	0.3	0.3	-1.1
IV. Effect of full depreciation recapture	0.0	-0.2	0.4	1.0	1.5	1.7	4.2
V. Effect of treating excluded gains as a preference item for AMT purposes	-0.1	-0.5	0.1	0.8	1.2	1.4	2.7
VI. Effective date of proposal 2/	0.0	0.3	0.0	0.0	0.0	0.0	0.3
VII. Total revenue effect of proposal	0.4	3.0	1.7	0.9	1.8	1.7	9.5

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Note: Details may not add to total due to rounding.

1/ This line reflects an estimate of the net effect of an increase in budget receipts attributable to taxpayer decisions to realize more capital gains, and a decrease in receipts resulting from conversion of ordinary income into capital gains and deferral of short-term gains as a result of lower tax rates.

2/ Lines I-V reflect January 1, 1991 effective date. Line VI represents an adjustment to these lines to reflect an assumed effective date of February 15, 1991.

Lines IV and V show the revenue effects of expanded depreciation recapture and treating excluded capital gains as a preference item for purposes of the alternative minimum tax. These two provisions are critical to turning the proposal from one that would otherwise probably lose revenue in the long run to one that is revenue-raising even beyond the budget period. Over the budget period, these two provisions raise \$6.9 billion in revenue. The full depreciation recapture proposal means that if a depreciable asset is sold, the exclusion will apply only to the amount by which the current selling price is higher than the original cost. Treating excluded gains as a preference item for purposes of the alternative minimum tax primarily affects high-income individuals and raises \$2.7 billion over the budget period. Line VI shows the revenue effect of making the effective date of the proposal February 15, 1991.

The total revenue effect of the proposal is shown in line VII. The proposal is expected to raise revenue in every year and \$9.5 billion over the budget period. Treasury's estimates indicate that the Administration proposal would produce increased revenues not only throughout the budget period, but for the foreseeable future.*

These estimates do not include the effects of potential increases in long-run economic growth expected from a lower capital gains tax rate. This conforms to the standard budget and revenue estimating practice of assuming that the macroeconomic effects of revenue and spending proposals are already included in the economic forecast.

* Because the methodological differences between OTA, Congressional estimators, and outside experts have not yet been resolved, the Budget reflects the deficit impact of the Administration's Pay-As-You-Go proposals with the Administration's estimates and with a zero (neutral) entry for capital gains rate reduction (see Table II-8, Part One, p. 18, of the Budget of the U.S. Government, Fiscal Year 1992).

FAMILY SAVINGS ACCOUNTS

Current Law

Taxation of Investment Income and Saving. Investment income earned by an individual taxpayer is generally subject to tax. The funds saved out of each year's income, which are used to make additional deposits to savings or other investment accounts, additional purchases of stocks or bonds, or to acquire other investments, are generally not deductible in calculating taxable income. The major exception is the tax treatment of retirement savings under certain tax-favored retirement savings arrangements, contributions to which are generally deductible and investment earnings of which are generally excludable from gross income. These investments are generally taxed when the amounts contributed and earned are later distributed.

Individual Retirement Accounts. The current law for Individual Retirement Accounts (IRAs) generally grants married taxpayers who do not participate in a qualified retirement plan or who have adjusted gross incomes (AGI) below \$50,000 the right to make deductible contributions to an IRA. There is a lower income threshold of \$35,000 if the taxpayer is unmarried. The deductibility of contributions for taxpayers participating in a qualified retirement plan is phased out as their AGI increases from \$10,000 below the income threshold up to the threshold. Taxpayers who do participate in a qualified retirement plan and who have adjusted gross incomes above these thresholds may make only nondeductible contributions to an IRA. Both deductible and nondeductible IRA contributions are limited to the lesser of \$2,000 or the individual's compensation for the year.

Married individuals who both work and otherwise qualify may each contribute to an IRA, so if each spouse has compensation of \$2,000 or more, each may contribute \$2,000. If only one spouse works, qualifying married individuals also have the opportunity to contribute an additional \$250 to an IRA for the nonworking spouse. The limit on deductible contributions to the IRA of a nonworking spouse is proportionately reduced for adjusted gross incomes in the applicable phase-out ranges.

Withdrawals from an IRA prior to age 59-1/2 are generally subject to a 10 percent additional tax. Except for distributions of amounts which were not deductible when contributed, IRA withdrawals are subject to regular income tax, and withdrawals must begin by age 70-1/2.

In economic terms, deductible IRAs effectively exempt investment income from taxation. (The income tax imposed on withdrawals merely recaptures the tax saved from deducting the contribution, plus interest on that tax savings; the investment income itself is effectively exempt from tax.) This favorable tax treatment provides an incentive to save; IRAs are designed to provide this incentive specifically for retirement savings. The tax exemption of investment income is also a feature of section 401(k) and other tax-qualified retirement arrangements. Nondeductible IRAs allow only a deferral of taxes on investment income, not an exemption.

Reasons For Change

There is general concern that the rate of national saving and investment is too low relative to that needed to sustain future growth and to maintain our relative economic position in comparison with the performance of other industrial nations. Addressing this problem requires that both public dissaving (the budget deficit) be reduced, and that private saving be increased. Incentives provided by the proposed Family Savings Accounts will provide an important incentive to encourage private saving.

The availability of savings accounts in the form of IRAs was sharply curtailed by the Tax Reform Act of 1986, which resulted in a large decline in IRA participation. Prior to the Act, any individual under the age of 70-1/2 could make deductible contributions, up to the current limits, to an IRA. One of the goals of the current proposal is to expand the availability and attractiveness of tax-exempt saving to a large segment of the population.

An additional goal of the current proposal is to expand savings incentives to income that is saved for other than retirement purposes, while not eroding incentives for retirement saving. The proposal recognizes that individuals save for many reasons: for down-payments on homes, for educational expenses, for large medical expenses, and as a hedge against uncertain income in the future.

Description of Proposal

The Family Savings Account (FSA) differs from a deductible current-law IRA in two respects: the contributions are not deductible, but if the account is maintained for at least seven years, neither the contributions nor the investment earnings are taxed when withdrawn. As in the case of IRAs, the economic effect of an FSA is to exempt investment income from taxation. The proposal would allow individuals (other than dependents) to make nondeductible contributions to an FSA up to the lesser of \$2,500 or the individual's compensation for the year. Contributions would be allowed for single filers with adjusted gross income (AGI) no more than \$60,000, for heads of households with AGI no more than \$100,000, and for married taxpayers filing joint returns with AGI no more than \$120,000. Contributions to FSAs would be allowed in addition to contributions to current-law qualified pension plans, IRAs, 401(k) plans, and other tax-favored forms of saving.

Earnings on contributions retained in the FSA for at least seven years would be eligible for full tax exemption upon withdrawal. However, withdrawals of earnings allocable to contributions retained in the FSA for less than three years would be subject to both a 10 percent additional tax and regular income tax. Withdrawals of earnings allocable to contributions retained in the FSA for three to seven years would be subject only to regular income tax. The proposal would be effective for years beginning on or after January 1, 1991.

Effects of Proposal

The proposal would increase the total amount of individual saving that can earn tax-free investment income. Generally, individuals would be able to contribute to FSAs, IRAs, 401(k) plans, and similar tax-favored plans, and would receive tax exemption on the investment income from each source.

The ability to contribute to an FSA would significantly raise the total amount of allowable contributions to tax-favored savings accounts. The contribution limit is \$5,000 for joint return filers as compared to the \$4,000 IRA limit for a working couple. These higher total contribution limits for FSAs will provide additional marginal incentives for personal saving. The higher eligibility limits on FSAs also expand the incentives to more taxpayers.

Despite the difference in structure, the value of the tax benefits in present value of an FSA per dollar of contribution is equivalent in terms of its tax treatment to the value of current-law deductible IRAs, assuming that tax rates are constant over time. Both FSAs and deductible IRAs effectively exempt all investment income from tax. The contributions to FSAs are not deductible, but the income tax imposed on withdrawals from an IRA effectively offsets the tax savings from the deduction of the contribution (plus interest on the tax savings). Individuals who expect higher tax rates when the funds are withdrawn would generally prefer the tax treatment offered in an FSA to that in an IRA. Conversely, individuals who expect lower future tax rates would generally prefer an IRA as a vehicle for retirement savings. However, the FSA offers more flexibility, because full tax benefits are available seven years after contribution and the account need not be held until retirement. This gives individuals an added degree of liquidity.

Revenue Estimate

	Fiscal Years						
	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1991-96</u>
	(Billions of Dollars)						
Family savings accounts:	-*	-.3	-.8	-1.3	-1.8	-2.3	-6.5

-* Revenue loss of less than \$50 million.

PENALTY-FREE IRA WITHDRAWALS FOR FIRST-TIME HOME BUYERS

Current Law

Married taxpayers who do not participate in a qualified retirement plan or who have adjusted gross incomes below \$50,000 generally may make deductible contributions to an Individual Retirement Account (IRA). There is a lower threshold of \$35,000 for unmarried taxpayers. The deductibility of contributions for taxpayers participating in a qualified retirement plan is phased out over the last \$10,000 below the income threshold for each income tax filing status. Taxpayers who do participate in a qualified retirement plan and who have adjusted gross incomes above these thresholds may make only nondeductible contributions to an IRA. Both deductible and nondeductible IRA contributions are limited to the lesser of \$2,000 or the individual's compensation for the year. Married individuals generally may contribute an additional \$250 to an IRA for a nonworking spouse.

Withdrawals from IRAs must begin by age 70-1/2. IRA withdrawals, except those from nondeductible contributions, are subject to income tax. In general, withdrawals from an IRA prior to age 59-1/2 are subject to a 10 percent additional tax.

Reasons For Change

The intent of this proposal is to expand savings incentives to income that is saved for first-time home purchases. Increased flexibility of IRAs would help to alleviate the difficulties that many individuals have in purchasing a new home.

The attractiveness and eligibility of IRAs for many taxpayers was sharply curtailed by the Tax Reform Act of 1986. This resulted in a large decline in IRA participation. Prior to the 1986 Act, any individual under the age of 70-1/2 could make deductible contributions, up to the current limits, to an IRA. The current proposal is designed to enhance the attractiveness of deductible IRAs by making them more flexible. This increased flexibility would provide an incentive for more taxpayers to save for the purchase of their first home.

Description of Proposal

The proposal would allow individuals to withdraw amounts of up to \$10,000 from their IRAs for a "first-time" home purchase. The 10 percent additional tax on early withdrawals would be waived for eligible individuals. Eligibility for penalty-free withdrawals would be limited to individuals who did not own a home in the last three years and are purchasing or constructing a principal residence that costs no more than 110 percent of the median home price in the area where the residence is located. The proposal would be effective for years beginning on or after January 1, 1991.

Effects of Proposal

This proposal will help encourage individuals to save for the purchase of a first home.

Revenue Estimate

	Fiscal Years						
	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1991-96</u>
	(Billions of Dollars)						
Penalty-free IRA withdrawals for first time home buyers:	-*	-.1	-.1	-.1	-.1	-.1	-.4

-* Revenue loss of less than \$50 million.

PERMANENT RESEARCH AND EXPERIMENTATION TAX CREDIT

Current Law

Present law allows a 20 percent tax credit for a certain portion of a taxpayer's "qualified research expenses." The portion of qualified research expenses that is eligible for the credit is the increase in the current year's qualified research expenses over its base amount for that year. The base amount for the current year is computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the four preceding years. A taxpayer's fixed-base percentage generally is the ratio of its total qualified research expenses for the 1984-88 period to its total gross receipts for this period. Special rules for start-up companies provide a fixed-base percentage of 3 percent. In no event will a taxpayer's fixed-base percentage exceed 16 percent. A taxpayer's base amount may not be less than 50 percent of its qualified research expenditures for the current year.

In general, qualified expenditures consist of (1) "in-house" expenditures for wages and supplies used in research; (2) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf; and (3) certain time-sharing costs for computers used in research. Restrictions further limit the credit to expenditures for research that is technological in nature and that will be useful in developing a new or improved business component. In addition, certain research is specifically excluded from the credit, including research performed outside the United States, research relating to style, taste, cosmetic, or seasonal design factors, research conducted after the beginning of commercial production, research in the social sciences, arts, or humanities, and research funded by persons other than the taxpayer.

The credit is available only for research expenditures paid or incurred in carrying on a trade or business of the taxpayer. A taxpayer is treated as meeting the trade or business requirement with respect to in-house research expenses if, at the time such in-house research expenses are incurred, the principal purpose of the taxpayer in making such expenditures is to use the results of the research in the active conduct of a future trade or business of the taxpayer or certain related taxpayers.

Present law also provides a separate 20 percent tax credit ("the university basic research credit") for corporate funding of basic research through grants to universities and other qualified organizations performing basic research. The university basic research credit is measured by the increase in spending from certain prior years. This basic research credit applies to the excess of (1) 100 percent of corporate cash expenditures (including grants or contributions) paid for university basic research over (2) the sum of a fixed research floor plus an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed base period (adjusted for inflation). A grant is tested first to see if it constitutes a basic research payment; if not, it may be tested as a qualified research expenditure under the general R&E credit.

The R&E credit is aggregated with certain other business credits and made subject to a limitation based on tax liability. The sum of these credits may reduce the first \$25,000 of regular tax liability without limitation, but may offset only 75 percent of any additional tax liability. Taxpayers may carry credits not usable in the current year back three years and forward 15 years.

The amount of any deduction for research expenses is reduced by the amount of the tax credit taken for that year.

The R&E credit in the form described above is in effect for taxable years beginning after December 31, 1989. However, the credit will not apply to amounts paid or incurred after December 31, 1991.

Reasons for Change

The current law tax credit for research provides an incentive for technological innovation. Although the benefit to the country from such innovation is unquestioned, the market rewards to those who take the risk of research and experimentation may not be sufficient to support the level of research activity that is socially desirable. The credit is intended to reward those engaged in research and experimentation of unproven technologies.

The credit cannot induce additional R&E expenditures unless its future availability is known at the time firms are planning R&E projects and projecting costs. R&E activity, by its nature, is long-term, and taxpayers should be able to plan their research activity knowing that the credit will be available when the research is actually undertaken. Thus, if the R&E credit is to have the intended incentive effect, it should be made permanent.

Description of Proposal

The R&E credit would be made permanent.

Effects of Proposal

Stable tax laws that encourage research allow taxpayers to undertake research with greater assurance of the future tax consequences. A permanent R&E credit (including the university basic research credit) permits taxpayers to establish and expand research activities without fear that the tax incentive would not be available when the research is carried out.

Revenue Estimate

	Fiscal Years						
	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1991-96</u>
	(Billions of Dollars)						
Permanent R&E tax credit:	0	-0.5	-1.0	-1.3	-1.6	-1.8	-6.2

RESEARCH AND EXPERIMENTATION EXPENSE ALLOCATION RULES

Current Law

The tax credit allowed for payments of foreign tax is limited to the amount of U.S. tax otherwise payable on the taxpayer's income from foreign sources. The purpose of this limitation is to prevent the foreign tax credit from offsetting U.S. tax imposed on income from U.S. sources. Accordingly, a taxpayer claiming a foreign tax credit is required to determine whether income arises from U.S. or foreign sources and to allocate expenses between such U.S. and foreign source income.

Under the above limitation rules, an increase in the portion of a taxpayer's income determined to be from foreign sources will increase the allowable foreign tax credit. Therefore, taxpayers generally receive greater foreign tax credit benefits to the extent that their expenses are applied against U.S. source income rather than foreign source income.

Treasury regulations issued in 1977 described methods for allocating expenses between U.S. and foreign source income. Those regulations contained specific rules for the allocation of research and experimentation (R&E) expenditures, which generally required a certain portion of R&E expense to be allocated to foreign source income. Absent such rules, a full allocation of R&E expense to U.S. source income would overstate foreign source income, thus allowing the foreign tax credit to apply against U.S. tax imposed on U.S. source income and thwarting the limitation on the foreign tax credit.

Since 1981 these R&E allocation regulations have been subject to seven different suspensions and temporary modifications by Congress. The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) adopted allocation rules which were in effect for only four months. For 20 months following the period when the TAMRA rules were in effect, R&E allocation was controlled by the 1977 Treasury regulations. The Budget Reconciliation Act of 1989 subsequently reintroduced the TAMRA rules, once again on a temporary basis. These rules were extended to taxable years beginning on or before August 1, 1991 by the Omnibus Budget Reconciliation Act of 1990.

Under the R&E allocation rules enacted by TAMRA (and temporarily recodified in 1989 and 1990), a taxpayer must allocate 64 percent of R&E expenses for research conducted in the United States to U.S. source income and 64 percent of foreign-performed R&E to foreign source income. The remaining portion can be allocated on the basis of the taxpayer's gross sales or gross income. However, the amount allocated to foreign source income on the basis of gross income must be at least 30 percent of the amount allocated to foreign source income on the basis of gross sales.

Reasons for Change

As evidenced by its continued support for a R&E credit, the Administration believes in the provision of tax incentives to increase the performance of U.S.-based research activities. The allocation rules in this proposal provide such an incentive. Although the proposal benefits only multinational corporations that are subject to the foreign tax credit limitation, it will provide an effective incentive with respect to such entities. By enhancing the return on R&E expenditures, the proposal promotes the growth of overall R&E activity as well as encouraging the location of such research within the United States.

Description of Proposal

The proposal would extend for one year the R&E allocation rules that were first enacted by TAMRA and were re-enacted on a temporary basis in 1989 and 1990. The proposal would be effective for all taxable years beginning after August 1, 1991 and ending on or before August 1, 1992.

Effects of Proposal

Under the proposal, the automatic allocation of 64 percent of U.S.-performed R&E to U.S. source income generally permits a greater amount of income to be classified as foreign source than the rules applicable under the 1977 regulations. As discussed above, this will increase the benefits of the foreign tax credit for many taxpayers.

The operation of these rules is best illustrated through an example. Assume that an unaffiliated U.S. taxpayer has \$100 of expense from research performed in the United States, that 50 percent of relevant gross sales produce foreign source income, and that 30 percent of the taxpayer's gross income is from foreign sources. Subject to certain limitations not applicable to these facts, the 1977 regulations would have required the taxpayer to allocate at least \$30 of R&E expense to foreign source income ($\$100 \times 30\%$ gross income from foreign sources).

Under the proposal \$64 is automatically allocated to U.S. source income based on the place of performance ($\$100 \times 64\%$). The remaining \$36 may be allocated either on the basis of gross sales or on the basis of gross income (subject to the limitation described below). A gross sales apportionment of the remainder would result in \$18 ($\$36 \times 50\%$) being allocated to foreign source income, while a gross income apportionment would result in \$10.80 ($\$36 \times 30\%$) being allocated to foreign source income.

The amount allocated to foreign source income using the gross income method must be at least 30 percent of the amount so allocated using the gross sales method. That limitation will not affect the result here since the \$10.80 apportioned to foreign source income under the gross income method is greater than \$5.40 ($\18 apportioned under gross sales $\times 30\%$ limitation).

As a result of the allocation rules in the proposal, the taxpayer in this example must allocate at least \$10.80 of U.S.-performed R&E expense to foreign source income, compared to the \$30 required to be so allocated under the 1977 regulations.

Revenue Estimate

	Fiscal Years						
	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1991-96</u>
	(Billions of Dollars)						
One year extension of R&E expense allocations:	0	-.3	-.3	0	0	0	-.6

ENTERPRISE ZONE TAX INCENTIVES

Current Law

Existing Federal tax incentives generally are not targeted to benefit specific geographic areas. Although the Federal tax law contains incentives that may encourage economic development in targeted economically distressed areas, the provisions generally are not limited to use with respect to such areas.

Among the existing general Federal tax incentives that aid economically distressed areas is the targeted jobs tax credit. This credit provides an incentive for employers to hire economically disadvantaged workers and often is available to firms located in economically distressed areas. A Federal tax credit also is allowed for certain investment in low-income housing or the rehabilitation of certain structures that may be located in economically distressed areas. Another Federal tax incentive permits the deferral of capital gains taxation upon certain transfers of low-income housing. In addition, tax-exempt state and local government bonds may be used to finance certain activities conducted in economically distressed areas.

Reasons for Change

To help economically distressed areas share in the benefits of economic growth, the Administration proposes to designate Federal enterprise zones which will benefit from targeted tax incentives and regulatory relief. The tax incentives and regulatory relief provided by this proposal will stimulate government and private sector revitalization of the areas.

Description of Proposal

The proposed enterprise zone initiative would include selected Federal income tax employment and investment incentives. These incentives will be offered in conjunction with Federal, state, and local regulatory relief. Up to 50 zones will be selected over a four-year period.

The incentives are: (i) a 5 percent refundable tax credit for qualified employees with respect to their first \$10,500 of wages earned in an enterprise zone (up to \$525 per worker, with the credit phasing out when the worker earns between \$20,000 and \$25,000 of total annual wages); (ii) elimination of capital gains taxes for tangible property used in an enterprise zone business and located within an enterprise zone for at least two years; and (iii) expensing by individuals of contributions to the capital of corporations engaged in the conduct of enterprise zone businesses (provided the corporation has less than \$5 million of total assets and uses the contributions to acquire tangible assets located within an enterprise zone, and limiting the expensing to \$50,000 annually per investor with a \$250,000 lifetime limit per investor).

The willingness of states and localities to "match" Federal incentives will be considered in selecting the special enterprise zones to receive these additional Federal incentives.

Effects of Proposal

Enterprise zones would encourage private industry investment and job creation in economically distressed areas by removing regulatory and other barriers inhibiting growth. They would also promote growth through selected tax incentives to reduce the risks and costs of operating or expanding businesses in severely depressed areas. A new era of public/private partnerships is needed to help distressed cities and rural areas help themselves.

Revenue Estimate

	Fiscal Years						
	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1991-96</u>
	(Billions of Dollars)						
Enterprise zone incentives:	0	-0.1	-0.2	-0.3	-0.5	-0.8	-1.8

SOLAR AND GEOTHERMAL ENERGY CREDITS

Current law

A tax credit is allowed for investment in solar or geothermal energy property. The amount of the credit is 10 percent of the investment. Solar property is equipment that uses solar energy to generate electricity or steam or to provide heating, cooling, or hot water in a structure. Geothermal property consists of equipment, such as a turbine or generator, that converts the internal heat of the earth into electrical energy or another form of useful energy. The credits for solar and geothermal property have been scheduled for expiration a number of times in recent years, but have been extended each time. The credits are currently scheduled to expire on December 31, 1991. A number of other energy credits, such as the credits for ocean thermal and wind energy property, have expired in recent years.

Reasons for Change

The geothermal and solar credits are intended to encourage investment in renewable energy technologies. Increased use of solar and geothermal energy would reduce our nation's reliance on imported oil and other fossil fuels and would improve our long-term energy security. Use of geothermal and solar energy resources also reduces air pollution.

Description of Proposal

The solar and geothermal credits would be extended through December 31, 1992.

Revenue Estimate

	Fiscal Years						
	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1991-96</u>
	(Billions of Dollars)						
One year extension of solar and geothermal energy credits:	0	-*	-*	*	*	*	-*

* Revenue gain of less than \$50 million.

-* Revenue loss of less than \$50 million.

TARGETED JOBS TAX CREDIT

Current Law

The targeted jobs tax credit (TJTC) is available on an elective basis for hiring individuals from nine targeted groups. The targeted groups are: (1) vocational rehabilitation referrals; (2) economically disadvantaged youths aged 18 through 22; (3) economically disadvantaged Vietnam-era veterans; (4) Supplemental Security Income (SSI) recipients; (5) general assistance recipients; (6) economically disadvantaged cooperative education students aged 16 through 19; (7) economically disadvantaged former convicts; (8) eligible work incentive employees; and (9) economically disadvantaged summer youth employees aged 16 or 17. Certification of targeted group membership is required as a condition of claiming the credit.

The credit generally is equal to 40 percent of the first \$6,000 of qualified first-year wages paid to a member of a targeted group. Thus, the maximum credit generally is \$2,400 per individual. With respect to economically disadvantaged summer youth employees, however, the credit is equal to 40 percent of up to \$3,000 of wages, for a maximum credit of \$1,200.

The credit is not available for wages paid to a targeted group member unless the individual either (1) is employed by the employer for at least 90 days (14 days in the case of economically disadvantaged summer youth employees), or (2) has completed at least 120 hours of work performed for the employer (20 hours in the case of economically disadvantaged summer youth employees). Also, the employer's deduction for wages must be reduced by the amount of the credit claimed.

The credit is available with respect to targeted-group individuals who begin work for the employer before January 1, 1992.

Reasons for Change

The TJTC is intended to encourage employers willing to hire workers who otherwise may be unable to find employment. Job creation incentives are required in the current economic climate.

Description of Proposal

The TJTC would be extended for one year. The credit would be available with respect to targeted-group individuals who begin work for the employer before January 1, 1992.

Revenue Estimate

	Fiscal Years						
	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1991-96</u>
	(Billions of Dollars)						
One year extension of targeted jobs tax credit:	0	-.1	-.1	-.1	-*	-*	-.3

-* Revenue loss of less than \$50 million.

DEDUCTION FOR SPECIAL NEEDS ADOPTIONS

Current Law

Expenses associated with the adoption of children are not deductible under current law. However, expenses associated with the adoption of special needs children are reimbursable under the Federal-State Adoption Assistance Program (Title IV-E of the Social Security Act). Special needs children are those who by virtue of special conditions such as age, physical or mental handicap, or combination of circumstances, are difficult to place for adoption. The Adoption Assistance Program includes several components. One of these components requires States to reimburse families for costs associated with the process of adopting special needs children. The Federal Government shares 50 percent of these costs up to a maximum Federal share of \$1,000 per child. Reimbursable expenses include those associated directly with the adoption process such as legal costs, social service review, and transportation costs. Some children are also eligible for continuing Federal-State assistance under Title IV-E of the Social Security Act. This assistance includes Medicaid. Other children may be eligible for continuing assistance under State-only programs.

Reasons for Change

The Tax Reform Act of 1986 (the 1986 Act) repealed the deduction for adoption expenses associated with special needs children. Under prior law, a deduction of up to \$1,500 of expenses associated with the adoption of special needs children was allowed. The 1986 Act provided for a new outlay program under the existing Adoption Assistance Program to reimburse expenses associated with the adoption process of these children. The group of children covered under the outlay program is somewhat broader than the group covered by the prior deduction. The prior law deduction was available only for special needs children assisted under Federal welfare programs, Aid to Families with Dependent Children, Title IV-E Foster Care, or Supplemental Security Income. The current adoption assistance outlay program provides assistance for adoption expenses for these special needs children, as well as special needs children in private and State-only programs.

Repeal of the special needs adoption deduction may have appeared to some as a lessening of the Federal concern for the adoption of special needs children.

An important purpose of the Adoption Assistance Program is to enable families in modest circumstances to adopt special needs children. In a number of cases the children are in foster care with the prospective adoptive parents. The prospective parents would like to formally adopt the child but find that to do so would impose a financial hardship on the entire family.

While the majority of eligible expenses are expected to be reimbursed under the continuing expenditure program, the Administration is concerned that in some cases the limits may be set below actual cost in high-cost areas or in special circumstances. Moreover, inclusion in the tax code of a deduction for special needs children may alert families who are hoping to adopt a child to the many forms of assistance provided to families adopting a child with special needs.

Description of Proposal

The proposal would permit the deduction from income of expenses incurred that are associated with the adoption of special needs children, up to a maximum of \$3,000 per child. Eligible expenses would be limited to those directly associated with the adoption process that are eligible for reimbursement under the Adoption Assistance Program. These include court costs, legal expenses, social service review, and transportation costs. Only expenses for adopting children defined as eligible under the rules of the Adoption Assistance Program would be allowed. Expenses which were deducted but reimbursed would be included in income in the year in which the reimbursement occurred. The proposal would be effective January 1, 1992.

Effects of Proposal

The proposal when combined with the current outlay program would assure that reasonable expenses associated with the process of adopting a special needs child do not cause financial hardship for the adoptive parents. The proposed deduction would supplement the current Federal outlay program. In addition, the proposal highlights the Administration's concern that adoption of these children be specially encouraged and may call to the attention of families interested in adoption the various programs that help families adopting children with special needs.

There is currently uncertainty regarding whether Federal and State reimbursements are income to the adopting families. The proposal would clarify the treatment of reimbursements by making them includable in income but also deductible, up to \$3,000 of eligible expenses per child. Additionally, qualified expenses up to this limit would be deductible even though not reimbursed.

While the costs of adoption of a special needs child are only a small part of the total costs associated with adoption of these children, the Administration believes that it is important to remove this small one-time cost barrier that might leave any of these children without a permanent family.

Revenue Estimate

	Fiscal Years					
	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>
						<u>1991-96</u>
	(Billions of Dollars)					
Deduction for special needs adoption:	0	-*	-*	-*	-*	-*

-* Revenue loss of less than \$50 million.

LOW-INCOME HOUSING TAX CREDIT

Current Law

A tax credit is allowed for certain expenditures with respect to low-income residential rental housing. The low-income housing credit generally may be claimed by owners of qualified low-income buildings in equal annual installments over a 10-year credit period as long as the buildings continue to provide low-income housing over a 15-year compliance period.

In general, the discounted present value of the installments may be as much as 70 percent of eligible expenditures. Eligible expenditures include the depreciable costs of new construction and substantial rehabilitations. They also include the cost of acquiring existing buildings which have been substantially rehabilitated so long as they have not been placed in service within the previous 10 years and are not already subject to a 15-year compliance period. The basis of property is not reduced by the amount of the credit for purposes of depreciation and capital gain.

The annual credit available for a building cannot exceed the amount allocated to the building by the designated State or local housing agency. As originally enacted, the total allocations by the housing agency in a given year could not exceed the product of \$1.25 and the State's population. A State credit allocation is not required, however, for certain projects financed with tax-exempt bonds subject to the State's private activity bond volume limitation.

States could not originally allocate the low-income housing credit after 1989. The Omnibus Budget Reconciliation Act of 1989 extended each State's allocation authority through 1990, but at a reduced annual level of \$0.9375 per state resident. The Omnibus Budget Reconciliation Act of 1990, however, increased the allocation authority for 1990 to \$1.25 per State resident and extended allocation authority through 1991 at the same annual level.

Reasons for Change

The low-income housing credit encourages the private sector to construct and rehabilitate the nation's rental housing stock and to make it available to the working poor and other low-income families. In addition to tenant-based housing vouchers and certificates, the credit is an important mechanism for providing Federal assistance to rental households.

Description of Proposal

The proposal would extend the authority of States to allocate the credit through 1992 at an annual level of \$1.25 per State resident.

Revenue Estimate

	Fiscal Years						<u>1991-96</u>
	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	
	(Billions of Dollars)						
One year extension of low-income housing tax credit:	0	-0.1	-0.2	-0.3	-0.3	-0.3	-1.3

HEALTH INSURANCE DEDUCTION FOR THE SELF-EMPLOYED

Current Law

Current law generally allows a self-employed individual to deduct as a business expense up to 25 percent of the amount paid during a taxable year for health insurance coverage for himself, his spouse, and his dependents. The deduction is not allowed if the self-employed individual or his or her spouse is eligible for employer-paid health benefits. Originally, this deduction was only available if the insurance was provided under a plan that satisfied the non-discrimination requirements of section 89 of the Code. Section 89 has since been repealed retroactively, however, and no non-discrimination requirements currently apply to such insurance. The value of any coverage provided for such individuals and their families by the business is not deductible for self-employment tax purposes. The deduction is scheduled to expire after December 31, 1991.

Reasons for Change

The 25 percent deduction for health insurance costs of self-employed individuals was added by the Tax Reform Act of 1986 because of a disparity between the tax treatment of owners of incorporated and unincorporated businesses (e.g., partnerships and sole proprietorships). Under prior law, incorporated businesses could generally deduct, as an employee compensation expense, the full cost of any health insurance coverage provided for their employees (including owners serving as employees) and their employees' spouses and dependents. By contrast, self-employed individuals operating through an unincorporated business could only deduct the cost of health insurance coverage for themselves and their spouses and dependents to the extent that it, together with other allowable medical expenses, exceeded 5 percent of their adjusted gross income. (Coverage provided to employees of the self-employed, however, was and remains a deductible business expense for the self-employed.) The special 25 percent deduction was designed to mitigate this disparity in treatment. Further, the Tax Reform Act of 1986 raised the floor for deductible medical expenses (including health insurance) to 7.5 percent of adjusted gross income.

Description of Proposal

The proposal would extend the 25 percent deduction through December 31, 1992.

Effects of Proposal

The proposal will continue to reduce the disparity in tax treatment between self-employed individuals and owners of incorporated businesses, compared to prior law.

Revenue Estimate

	Fiscal Year						
	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1991-96</u>
	(Billions of Dollars)						
One year extension of health insurance deduction for the self-employed:	0	-.1	-.2	0	0	0	-.4

EXTEND TAX DEADLINES FOR DESERT SHIELD/STORM PARTICIPANTS

Current Law

Section 7508 of the Internal Revenue Code generally suspends the time for performing various acts under the internal revenue laws, such as filing tax returns, paying taxes or filing claims for refund of tax, for any individual serving in the Armed Forces of the United States or in support of the Armed Forces in an area designated as a combat zone. The designation of a combat zone must be made by the President of the United States by Executive Order.

The suspension of time provided by section 7508 (prior to its recent amendment, discussed below) covers the period of service in the combat zone, including any period during which the individual is a prisoner of war or missing in action, any period of continuous hospitalization outside the United States as a result of injuries suffered in such service, and the next 180 days thereafter. The spouse of a qualifying individual is generally entitled to the same suspension of time, regardless of whether a joint return is filed. No interest is charged during the suspension period on underpayments of tax, and (prior to the recent amendment, discussed below) no interest is credited during the suspension period on overpayments of tax. Special rules apply if the collection of tax is in jeopardy.

On January 21, 1991, the President signed Executive Order 12744, designating as a combat zone the Persian Gulf, the Red Sea, the Gulf of Oman, a portion of the Arabian Sea, the Gulf of Aden, and the total land areas of Iraq, Kuwait, Saudi Arabia, Oman, Bahrain, Qatar and the United Arab Emirates. This designation is retroactive to January 17, 1991 (January 16 in the United States), the date specified as the commencement of combatant activities. As a result of this action, qualifying individuals serving in the combat zone will have the benefit of section 7508 beginning on January 17, 1991. Under regulations, members of the Armed Forces serving outside the combat zone in direct support of military operations in the combat zone, under conditions qualifying for compensation under 37 U.S.C. § 310 (relating to duty subject to hostile fire or imminent danger), are also entitled to the benefit of section 7508.

On January 30, 1991, the President signed into law legislation (P.L. 102-2) which amends section 7508 in several respects, effective August 2, 1990. First, it extends the coverage of section 7508 to include individuals serving in the Armed Forces or in support of the Armed Forces in the "Persian Gulf Desert Shield area" (to be designated by Executive Order) at any time during the period beginning August 2, 1990 and ending on the date on which any part of the area is designated by the President as a combat zone. As under current law, relief also extends to spouses of qualifying individuals. Second, the Desert Shield legislation reverses the prior rule in section 7508 regarding interest on overpayments of tax, so that interest is generally credited during the suspension period. Finally, the Desert Shield legislation extends the suspension period to include periods of continuous hospitalization in (as well as outside of) the United States. Not more than five years of hospitalization in the United States can be taken into account for this purpose, however, and hospitalization in the United States is not taken into account in determining the suspension period for the individual's spouse.

Reasons for Change

At the time the proposal was developed, the Persian Gulf area was not a combat zone and the Desert Shield legislation had not been enacted. There was accordingly a need to extend the coverage of section 7508 to individuals participating in the Desert Shield operation, many of whom were sent to the Middle East on short notice with little time to make provision for the filing of tax returns and payment of taxes.

Description of Completed Action

Enactment of the Desert Shield legislation and the promulgation of Executive Order 12744 have implemented the proposal discussed in the Budget.

Revenue Estimate

	Fiscal Years						
	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1991-96</u>
	(Billions of Dollars)						
Extend tax deadlines for Desert Shield/Storm participants	-*	*	*	0	0	0	-*

* Revenue gain of less than \$50 million.

-* Revenue loss of less than \$50 million.

Note: This revenue estimate was prepared prior to the designation of the Persian Gulf area as a combat zone and the enactment of the Desert Shield legislation. Because this proposal is now a feature of current law, the revenue loss is zero, but the baseline receipts forecast must be adjusted by a corresponding amount.

MEDICARE HOSPITAL INSURANCE (HI) FOR STATE AND LOCAL EMPLOYEES

Current Law

State and local government employees hired on or after April 1, 1986, are covered by Medicare Hospital Insurance and their wages are subject to the Medicare tax (1.45 percent on both employers and employees). Unless a State or local government had a voluntary agreement with Social Security, employees hired prior to April 1, 1986, are not covered by Medicare Hospital Insurance nor are they subject to the tax.

Reasons for Change

State and local government employees are the only major group of employees not assured Medicare coverage. One out of six State and local government employees are not covered by voluntary agreements or by law. However, an estimated 85 percent of these employees receive full Medicare benefits through their spouse or because of prior work in covered employment. Over their working lives, they contribute on average only half as much tax as is paid by workers in the private sector. Extending coverage would assure that the remaining 15 percent have access to Medicare and would eliminate the inequity and the drain on the Medicare trust fund caused by those who receive Medicare without contributing fully.

Description of Proposal

As of January 1, 1992, all State and local government employees would be covered by Medicare Hospital Insurance.

Effects of Proposal

An additional two million State and local government employees would contribute to Medicare. Of these, roughly 300,000 employees would become newly eligible to receive Medicare benefits subject to satisfying the minimum 40 quarters of covered employment.

Revenue Estimate*

	Fiscal Years						
	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1991-96</u>
(Billions of Dollars)							
Extend Medicare hospital insurance coverage to State and local employees:	0	1.1	1.5	1.5	1.5	1.5	7.3

* Net of income tax offset.

MOTOR FUELS EXCISE TAX

Current Law

The Omnibus Budget Reconciliation Act of 1990 raised the motor fuels excise tax by 5.1 cents from 9 to 14.1 cents a gallon on motor gasoline and from 15 to 20.1 cents a gallon on diesel fuel. One-tenth of a cent is deposited into the Leaking Underground Storage Tank Trust Fund, and half of the remaining 5 cent increase is deposited into the General Fund. The remaining 2.5 cents are deposited into the Highway Trust Fund. The General Fund and Highway Trust Fund portions of the tax are scheduled to expire at the end of fiscal year 1995.

Current services forecasts incorporate extension of the trust fund portions of the tax at their current rates through the end of the budget period, but provide that the General Fund portion of the tax expires as scheduled at the end of the fiscal year 1995. Thus, the highway portion of the motor fuels excise tax rates in fiscal year 1996 underlying the current services forecasts are 11.5 cents per gallon on gasoline and 17.5 cents per gallon on diesel fuel.

Reasons for Change

The current motor fuels excise taxes expire at the end of fiscal 1995. While the current services forecasts incorporate extension of the highway portion of the motor fuels tax at their current rates of 11.5 cents for gasoline and 17.5 cents for diesel fuel, the Administration Budget proposal incorporates extension in 1996 at the prior rates of 9 cents for gasoline and 15 cents for diesel fuel. The lower rates in 1996 will be sufficient to finance the Administration's proposed increase in highway and transit programs.

Description of Proposal

In contrast to the current services forecasts, under the Administration's proposal the portion of the motor fuels excise taxes which is dedicated to the Highway Trust Fund will be extended for fiscal year 1996 at the level of 9 cents per gallon on gasoline and 15 cents per gallon on diesel fuel.

Revenue Estimate

	Fiscal Years						
	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1991-96</u>
	(Billions of Dollars)						
Limited extension of motor fuels excise taxes:	0	0	0	0	0	-2.7	-2.7

INCREASE IN IRS FY 1992 ENFORCEMENT FUNDING

Current Law

The IRS currently allocates substantial resources to direct enforcement of the tax laws. Direct enforcement encompasses activities designed to encourage accurate reporting of taxable income and to assess or collect taxes, penalties, and interest which are owed but not paid. In allocating resources to these activities, the IRS does not simply seek to collect the maximum amount of taxes through direct enforcement activities; the additional objective is to increase tax revenues indirectly by encouraging and enhancing voluntary compliance.

Reasons for Changes

The IRS has identified a number of enforcement areas in which specific problems exist that could be resolved by the application of additional resources. In addition, the gap between taxes owed and taxes voluntarily paid contributes to the Federal deficit and undermines the system of voluntary compliance.

Description of Proposal

The proposal calls for additional IRS funding for tax law enforcement, and for the collection of delinquent taxes, penalties, and interest. The specific programs, new budget authority, and estimated FY 1992 receipts are as follows:

- o Examination Field Audit Initiative--An additional 94 staff years are to be applied to income tax audits. Total budget authority for the initiative for FY 1992 is \$6.0 million.
- o Collection of Accounts Receivable--This initiative will apply an additional 671 staff years with total FY 1992 budget authority of \$34.0 million, to the accounts receivable inventory.

Effects of Proposal

All affected activities are in the area of direct enforcement. Consequently, the proposal should enhance the level of revenue collection, encourage taxpayers to correctly report their income for tax purposes, and expedite the collection of past due taxes.

Revenue Estimate

	Fiscal Years						<u>1991-96</u>
	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	
	(Billions of Dollars)						
Increase in IRS FY 1992 enforcement funding:	0	*	0.1	0.2	0.2	0.2	0.7

* Revenue gain of less than \$50 million.

MISCELLANEOUS PROPOSALS AFFECTING RECEIPTS

Description of Proposals

Extend abandoned mine reclamation fees. The abandoned mine reclamation fees, which are scheduled to expire on September 30, 1995, would be extended. Collections from the existing fees of 35 cents per ton for surface mined coal and 15 cents per ton for under ground mined coal are allocated to States for reclamation grants. Extensive abandoned land problems are expected to exist in certain States after all the money from the collection of existing fees is expended.

Improve retail compliance with the special occupation taxes. To increase compliance rates and revenues, wholesalers would be required to ensure that their retail customers pay the special taxes in connection with liquor occupations that are levied on retailers. The proposal would be effective beginning October 1, 1991.

Increase HUD interstate land sales fee. The Interstate Land Sales Full Disclosure Act gives HUD the responsibility of registering certain subdivisions that are sold or leased across state lines. A fee is charged when a developer files a statement of record about the subdivision with HUD. The fee charged cannot exceed \$1,000 for any one developer. The fees collected cover only a portion of administrative costs. The proposal would remove the \$1,000 fee limitation to help fully offset the direct administrative costs of the program.

Amend railroad unemployment insurance (UI) status. Under present law, all railroads, including Amtrak and other public commuter railroads, make experience-rated UI contributions that are based partly on industry-wide unemployment costs and partly on their own line's unemployment costs. To prevent public subsidies from being diverted to pay for the high unemployment cost of the private sector railroads, public commuter railroads were exempt from the full railroad unemployment tax rate in 1990. Instead, they reimbursed the UI trust funds for the actual unemployment and sickness insurance costs of their employees. Under the proposal, Amtrak and other public commuter railroads would reimburse the trust funds for the actual unemployment costs of their employees after January 1, 1991.

Revenue Estimate

	Fiscal Year						<u>1991-1996</u>
	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	
	(Billions of Dollars)						
Extend abandoned mine reclamation fees:	0	0	0	0	0	.3	.3
Improve retail compliance with liquor occupation taxes:	0	*	*	*	*	*	.1
Increase HUD interstate land sales fee:	*	*	*	*	*	*	*
Amend railroad UI status:	-*	*	*	*	-*	-*	*

* Revenue gain of less than \$50 million.

-* Revenue loss of less than \$50 million.

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