General Explanations
of the
President's Budget Proposals
Affecting Receipts

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CAPITAL GAINS TAX RATE REDUCTION FOR INDIVIDUALS

Current Law

Under current law, capital gains of individuals are taxed at the same rates as ordinary income. Thus, capital gains are subject to a 15 percent, 28 percent, or 33 percent marginal rate, although the overall rate on all income cannot exceed 28 percent. Prior to the Tax Reform Act of 1986 (the "1986 Act"), the tax code provided an exclusion for capital gains. The elimination of the capital gains exclusion had the effect of increasing the rate of tax on capital gains. While the 1986 Act eliminated the capital gains exclusion, it did not eliminate the legal distinction between capital gains and ordinary income. Thus, the tax code retains most of the pre-1987 structure that implemented the capital gains tax rate differential.

Gains or losses from the sale or exchange of capital assets held for more than one year are treated as long-term capital gains or losses. A taxpayer determines net capital gain by first netting long-term capital gain against long-term capital loss and short-term capital gain against short-term capital loss. The excess of any net long-term capital gain over any net short-term capital loss equals net capital gain. Individuals with an excess net capital loss may generally take up to $3,000 of such loss as a deduction against ordinary income. A net capital loss in excess of the deduction limitations may be carried forward indefinitely, retaining its character in the carryover year as either a short-term or long-term loss. Special rules allow individuals to treat losses with respect to a limited amount of stock in certain small business corporations as ordinary losses rather than as capital losses.

A capital asset is defined generally as property held by a taxpayer other than (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business; (2) depreciable or real property used in the taxpayer's trade or business; (3) rights to literary or artistic works held by the creator of such works, or acquired from the creator in certain tax-free transactions; (4) accounts and notes receivable; and (5) certain publications of the government.

Special rules apply to gains and losses with respect to "section 1231 property." Section 1231 property is defined as (1) depreciable or real property held for more than 6 months and used in a taxpayer's trade or business, but not includable in inventory or held primarily for sale in the ordinary course of a trade or business; (2) certain property subject to compulsory or involuntary conversion; and (3) special 1231 property, including certain interests in timber, coal, domestic iron ore, certain livestock, and certain unharvested crops. Gains and losses from all transactions involving section 1231 property are netted for
each taxable year. Only gains that are not subject to recapture as ordinary income are included in the netting. If there is a net gain from section 1231 property, all gains and losses from section 1231 property are treated as long-term capital gains and losses and are combined with the taxpayer's other capital gains and losses. If there is a net loss from section 1231 property, all transactions in section 1231 property produce ordinary income and ordinary loss. However, net gain from section 1231 property is converted into ordinary income to the extent net losses from section 1231 property in the previous 5 years were treated as ordinary losses.

Depreciation recapture rules recharacterize a portion of gain realized upon the disposition of depreciable property as ordinary income. These rules vary with respect to the type of depreciable property. Under ACRS, for all personal and nonresidential rental real property, all previously allowed depreciation, not in excess of total realized gain, is recaptured as ordinary income. However, if a taxpayer elects straight-line depreciation over a longer recovery period, there is no depreciation recapture upon disposition of the asset. With respect to residential rental property, only the excess of ACRS deductions over the straight-line method is recaptured as ordinary income. Depreciation recapture also is imputed to a partner who sells a partnership interest if recapture would have been imposed upon disposition by the partnership of depreciable property. There are also recapture rules applicable to depletable property.

Capital gains and losses are generally taken into account when "realized" upon sale, exchange, or other disposition of the property. Certain dispositions of capital assets, such as transfers by gift, are not generally realization events for tax purposes. Thus, 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 into the hands of the donee. In certain circumstances, 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. Gain or loss also is not realized on a transfer at death.

The amount of a seller's gain or loss is equal to the difference between the amount realized by the seller and the seller's adjusted basis (i.e., the cost or other original basis adjusted for items chargeable against or added to basis). Under various nonrecognition provisions, however, realized gains and losses in certain transactions are deferred for tax purposes. Examples of such nonrecognition transactions include certain like-kind exchanges of property, involuntary conversions followed by an acquisition of replacement property, corporate reorganizations, and the sale of a principal residence. Generally, nonrecognition treatment defers gain or loss for tax purposes by providing for a substitution of basis from the old
property to the new or for a carryover basis from the old holder to the new holder.

Reasons for Change

Restoring a capital gains tax rate differential is essential to promote savings, entrepreneurial activity, and risk-taking investments in new products, processes, and industries that will help keep America competitive and economically strong. At the same time, investors should be encouraged to extend their horizons and search for investments with long-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 long-term commitments of capital will encourage investment patterns that favor innovations and long-term growth over short-term profitability.

A capital gains differential will also provide a rough adjustment for taxing inflationary gains that do not represent any increase in real income. In addition, the Administration believes it is appropriate to provide further capital gains benefit to low and moderate income individuals, who less frequently make direct investments in capital assets and whose capital gains tend to be disproportionately attributable to inflation.

Long-range Investment and Competitiveness. The Administration is committed to maintaining and enhancing American leadership in employment growth and entrepreneurial activity. A great strength of the American economy has been the rate of new business formation, product and process innovation, and leadership in new and emerging technologies. This has led to record new job creation this decade, a period for which most other major industrial economies have suffered stagnant employment.

By reducing the top individual income tax rate to its lowest level in more than half a century and by introducing the lowest marginal tax rates among the major industrial economies of the world, the 1986 Act created strong incentives for individual work, savings, and investment that will lead to long-term economic growth. These low tax rates are now being emulated by our major trading partners -- including especially Canada, the United Kingdom, Germany, and Japan -- who wish to get back in step with the United States. While low marginal tax rates were an enormous step forward, the Tax Reform Act of 1986 also raised the rate of tax on capital gains. In this area, our major competitors now have the upper hand: none of them taxes long-term capital gains in full. Restoring a tax differential for capital gains will solidify the favorable tax position of the
United States relative to the major industrial nations of the world.

Some of the soundest investments in America's future do not have immediate payoffs. Thus, it is important to the future competitive position of this country that investors look beyond short-run profit to an investment's long-term potential. Consequently, restoration of a capital gains tax rate differential should be tailored to encourage sound, long-term investments that require multi-year commitments of capital. Moreover, a tax rate differential will promote personal savings to finance long-term investment and will ameliorate the built-in bias of the income tax against corporate equity financing.

Inflationary Gains. Although inflation has been kept low under policies of the past eight years, even low rates of inflation mean that individuals who sell capital assets at a nominal profit are paying tax on a "fictional" element of profit represented by inflation. High rates of inflation, such as those that existed in the mid and late 1970s, exacerbate the problem. An income tax should consider only "real" changes in the value of capital assets -- after adjusting for inflation -- in order to avoid unintended high effective rates of tax that actually lower the real after-tax value of assets. Current law taxation of nominal capital gains in full has the perverse result that real gains are overstated (and taxed too highly) and real losses are understated and, in some cases, actually converted for tax purposes from losses to gains. A partial exclusion for long-term capital gains provides a rough adjustment for the inflationary element of capital gains without creating the complexities and additional record-keeping that a precise inflation adjustment would require.

Low and Moderate Income Taxpayers. Low and moderate income individuals typically do not directly realize capital gains as frequently as those with higher incomes. In 1985, the latest year for which detailed tax return data are available, nearly 60 percent of all returns reported adjusted gross incomes less than $20,000, but, as shown on table 1, only 30 percent of the returns with net long-term capital gains fell into this group, and their gains were only 11.4 percent of the total dollar value of gains realized that year. Economic studies of the behavioral reactions of individuals to changes in the taxation of capital gains suggest that lower income individuals are much less responsive than higher income taxpayers to capital gains tax rate changes, thus an extra measure of incentive is required to encourage lower income individuals to make direct capital investment in America's future. Further, analysis of capital gains realized by individuals at different income levels shows that lower income individuals are much more likely than higher income individuals to have large fractions of their gains represented by inflation. For these two reasons -- targeted extra incentive and fairness --
it is appropriate to provide special capital gains tax relief for lower income taxpayers.

Collectibles. Investment in so-called collectibles, which include works of art, stamp and coin collections, antiques, valuable rugs, and similar items does relatively little to enhance the nation's economic growth or productivity. For this reason collectibles do not warrant the preferential treatment accorded other capital investments.

Treatment of Gain on Depreciable and Depletable Assets. Gains and losses from sales of other dispossession of depreciable and depletable property should be treated in the same manner as other business income or loss and gains or losses from sales of other business property (e.g., inventory). The asymmetrical treatment of gains and losses from such depreciable or depletable property provided by pre-1987 law, i.e., the availability of capital gain treatment for gains and ordinary loss treatment for losses, is without justification as a matter of tax policy.

Historically, the availability of capital gain treatment for gains from sales of depreciable assets stems from the implementation of excess profits taxes during World War II. Many depreciable assets, including manufacturing plants and transportation equipment, had appreciated substantially in value when they became subject to condemnation or requisition for military use. Congress determined that it was unfair to tax the entire appreciation at the high rates applicable to wartime profits. Accordingly, gains from wartime involuntary conversions were taxed as capital gains. The provision was extended to voluntary dispositions of assets because it was not practical to distinguish condemnations and involuntary dispositions from sales forced upon taxpayers by the implicit threat of condemnation or wartime shortages and restrictions. These historical circumstances offer no justification for returning to the pre-1987 treatment of depletable or depreciable assets used in a trade or business, given the absence of exceptional wartime gains and the low, historically unprecedented (in the post-World War II era) statutory tax rates.

The timing of sales of depreciable or depletable business assets is more likely to be determined by the condition of the particular asset or by routine business cycles of replacement than would be true of capital assets held by investors. As a consequence, taxation of gains on sales of depreciable or depletable business assets at ordinary rates is less likely to affect taxpayer decisions about sales and reinvestment. Conversely, taxation of gains on sales of depreciable or depletable assets at preferential rates would create an undesirable bias toward certain sources of business income.

Depletion and depreciation deductions provide a current benefit in the years in which they are claimed. The effect of the recapture rules may be to offset this benefit, in whole or in
part, by preventing the conversion of ordinary income into capital gain, which was a significant issue under pre-1987 law. Such rules are complex, however, and one of the significant policy advantages of current law is the greatly reduced significance of recapture rules. Excluding gains on deplettable and depreciable business property from preferential treatment would preserve the limited significance of current recapture rules.

Finally, the availability of a capital gain preference prior to 1987 for depreciable and deplettable business property contributed significantly to tax shelter activity. Although the passive loss rules adopted in the 1986 Act have limited tax shelter benefits, restoration of a capital gain preference for depreciable and deplettable business property would make tax shelter investments more attractive.

Treatment of Gain on Special Section 1231 Property. Under pre-1987 law, gains on dispositions of certain interests in timber, coal, iron ore, livestock and unharvested crops, were eligible for favorable capital gain treatment without regard to whether the property was held for sale in the ordinary course of the taxpayer's business. This special treatment violated the distinction, which is inherent in the definition of a capital asset, between investment property and business property. Business income, whether derived from the sale of property used in a trade or business or from the sale of property to customers in the ordinary course of business, should be taxed as ordinary income. The preferential tax rate on capital gains should apply only to investment assets. Gains from dispositions of interests in certain natural and agricultural resources should be taxed in accordance with these generally applicable rules.

Description of Proposal

General Rule. An exclusion would be allowed to individuals for 45 percent of the gain realized upon the disposition of qualified capital assets. The maximum tax rate applicable to any gains on qualified assets would be 15 percent. A qualified asset would generally be defined as any asset that qualifies as a capital asset under current law and satisfies the phased-in holding periods. For example, assuming the holding period is satisfied, an individual's residence would be a qualified asset and gain on its disposition would be eligible for the lower capital gains rate proposed by the budget (and continued rollover of gain and the $125,000 one-time exclusion). Disposition of a qualified asset by an RIC, REIT, partnership, or other passthrough entity would continue to be treated as capital gain under the budget proposal and would be eligible for the exclusion in the hands of individual investors.
Holding Period and Effective Date. To be treated as qualified assets eligible for the lower capital gains rate, assets will need to satisfy the following holding periods: more than 12 months for assets sold in 1989, 1990, 1991, and 1992; more than 24 months for assets sold in 1993 and 1994; and more than 36 months for assets sold in 1995 and thereafter.

The proposal would be effective generally for dispositions of qualified assets after June 30, 1989. Dispositions of qualified assets after that date would be fully protected by the exclusion or maximum rate -- that is, there would be no blended rate for gains realized in 1989 after June 30. Conversely, gains realized on or before June 30, 1989, would not be eligible for the exclusion, maximum rate, or any of the other provisions of the proposal and would be taxable under current law.

15 Percent Maximum Rate. A 15 percent maximum tax rate would apply to capital gains on qualified assets. This maximum rate would apply for purposes of both regular and minimum tax. Thus while a taxpayer's ordinary income may be subject to a 33 percent marginal rate (due to phase-out of the 15 percent rate or personal exemptions), capital gains would not be subject to a marginal rate exceeding 15 percent. In some cases, the application of a 45 percent exclusion would result in an effective tax rate lower than 15 percent; for example, if the taxpayer's marginal rate is 15 percent, a 45 percent exclusion would result in an effective tax rate of 8.25 percent.

100 Percent Exclusion for Certain Taxpayers. A taxpayer would be eligible for a 100 percent exclusion on sales of qualified assets if the taxpayer's adjusted gross income is less than $20,000 and the taxpayer is not subject to the alternative minimum tax. The $20,000 amount would be calculated taking the 45 percent capital gains exclusion into account. Thus, if a taxpayer's adjusted gross income is $22,000 (including the full amount of gains realized on capital assets), and a 45 percent exclusion on capital gains would reduce the taxpayer's taxable income to less than $20,000, the taxpayer would be eligible for the 100 percent exclusion.

The $20,000 figure applies to married taxpayers filing jointly and heads of households. Single taxpayers and married taxpayers filing separately would be eligible for the 100 percent exclusion if their adjusted gross incomes are less than $10,000.

Taxpayers who are subject to the alternative minimum tax would not be eligible for the 100 percent exclusion. In making this determination, a taxpayer's tentative minimum tax would be compared with his regular tax computed using a 45 percent exclusion. If the tentative minimum tax exceeds the regular tax, the taxpayer has liability under the alternative minimum tax and would not be eligible for the 100 percent exclusion. The ineligibility for the 100 percent rate would have no other effect on the taxpayer. Consideration will given to the need for other
rules to restrict the 100 percent exclusion to true low-income families.

Collectibles Not Treated as Qualified Assets. The budget proposal would deny capital gain treatment for gains realized upon the disposition of collectibles, as defined under the individual retirement account (IRA) rules. These rules prohibit investments by IRAs in collectibles, which are defined to include works of art, rugs, antiques, metals, gems, stamps, alcoholic beverages, and most coins. The Secretary of the Treasury is also given authority to specify other tangible personal property to be treated as collectibles. Proposed regulations define collectibles to include musical instruments and historical objects. Consideration would also be given to rules denying the capital gains preference to sales of corporate stock to the extent collectibles had been contributed to the corporation by the selling shareholders.

Definition of Capital Asset and Treatment of Assets Used in a Trade or Business. The budget proposal would not alter the definition of a capital asset; however, gain from the sale, exchange, or other disposition of depreciable or depletable property used in a trade or business would not be treated as gain eligible for the lower capital gains rates. For this purpose, depreciable property refers to any property which is of a character subject to an allowance under Code sections 167 or 168. Thus, gains realized on the disposition of intangible property, the cost of which may be recovered through amortization deductions (see section 1.167(a)-3), such as sports player contracts, would be treated as ordinary income if the intangible property is used in the taxpayer's trade or business. The fact that cost recovery of an intangible asset may be referred to as "amortization" would not prevent its being treated as depreciable property under this provision. Depletable property refers to any property of a character that is subject to an allowance for depletion, whether cost or percentage depletion.

Under current law, gains on dispositions of special section 1231 assets, which include certain interests in timber, coal, iron ore, livestock, and unharvested crops, are eligible for capital gain treatment regardless of whether the property is held for investment or used in the ordinary course of the taxpayer's trade or business. Under the budget proposal, gains from such assets would not automatically be treated as capital gain eligible for the lower rate. Instead, the character of gain upon the sale, exchange, or other disposition of such assets would depend on generally applicable principles.

Gains on nondepreciable property that is used in a trade or business and is not held for sale in the ordinary course of business would be eligible for the lower capital gains rates. Losses on such property would also be treated as capital losses. Thus, for example, gain or loss realized on the disposition of...
land that is used in a trade or business and is not held for sale to customers would be treated as capital gain or loss.

Effects of Proposal

The proposal would restore incentives for investment and risk taking that may have been discouraged by elimination of a capital gains tax differential in the Tax Reform Act of 1986. The proposal would especially encourage long-run investments, which would lead to new jobs, the creation of new technologies, and economic growth. By more narrowly defining assets eligible for preferential treatment and by lengthening the prior-law holding period to 3 years, the proposal targets tax benefits to assets which are most responsive to a change in tax rate.

Under the proposal most taxpayers would be eligible for the 45 percent or 100 percent exclusions; however, most gains would be taxed at the alternate 15 percent rate. The following examples illustrate how the proposal would effect typical taxpayers. (Taxes have been computed using current law rates and other provisions applicable to 1989.)

Example A. Taxpayer A is a single individual earning $16,000. For some years he has been making modest investments in a mutual fund that in 1990 reports his share of long-term capital gain to be $750.

Under current law his tax on the $750 capital gain would be 15% of the full $750 gain, or $112.50.

Under the proposed general 45 percent exclusion his tax on the gain would be 15 percent of $412.50 (after excluding $337.50), or $61.88; however because Taxpayer A has adjusted gross income that is less then $20,000, he is eligible for the special 100 percent long-term capital gains exclusion, resulting in a tax of zero, a 100 percent reduction from current law tax.

Example B. Couple B both work and earn $90,000 between them. They also have interest income of $3,200 and dividend income of $1,800. They have two dependent children and have itemized deductions of $7,000.

In 1995 they sell corporate stock, realizing an $1,800 capital gain on stock held 15 months and a $3,700 capital gain on stock held 38 months.

Under current law both gains are subject to full taxation at the 33 percent effective marginal tax rate. Tax on the $1,800 gain would be $594, and tax on the $3,700 gain would be $1,221, for a combined tax of $1,815. Under the proposal, the gain from the 1995 sale of stock held 15 months will be short-term capital gain taxable at ordinary income rates, but
the gain from the sale of stock held 38 months is subject to the 15 percent maximum alternate capital gains tax rate (which for them is more beneficial than the 45 percent exclusion). Their tax on the latter gain will be $555.00, representing a reduction from current law of $666, or 55 percent.

Example C. Taxpayer C is a widow with dividend income of $23,000 and $7,000 of taxable pension income. In 1993 she sells corporate stock she had purchased over a number of years. The most recent purchase had been made more than 2 years previously. Her realized capital gains total $18,000.

Under current law her tax on that gain would be $5,040 (28 percent of $18,000). Under the proposal, the 15 percent rate cap will lower this capital gains tax to $2,700, a reduction of $2,340, or 46 percent.

Revenue Estimate

The effect on Federal tax revenues of changes in capital gains tax rates is controversial. Studies using different data, different explanatory variables, and different statistical methodologies have reached opposite conclusions on the effect of capital gain rate reductions on Federal revenues.

The Treasury Department estimates that the revenue effect of the President's proposal will be positive during the budget period, as well as in the long-run, after the phase-in of the three-year holding period requirement. The methodology used for these estimates is described below in more detail than usual since the President's proposal is different from proposals previously evaluated and generalizing from previous proposals can be misleading.

The revenue estimate for the budget proposal is generally consistent with the Treasury Department's estimate of the capital gains tax changes included in the 1986 Act; however, the proposal differs significantly from a simple reversal of the general increase in capital gains tax rates in the 1986 Act: (1) The proposal excludes gains on certain assets whose realizations are less responsive to changes in capital gains tax rates; (2) the proposal requires a longer holding period for gains to benefit from the lower rates; and (3) the proposal has a different time pattern between the announcement and effective date. Most importantly, in terms of its impact on revenues, the proposal creates a much smaller differential between the tax rate on capital gains and the tax rate on ordinary income than existed prior to the 1986 Act.

As described below, the Treasury revenue estimates assume significant behavioral effects as taxpayers adjust their capital
gain realizations, their financial portfolios and income sources, and the timing of their realizations to the new tax rules. These behavioral effects are the subject of continued empirical research. Studies will differ on the magnitude of these behavioral effects, in part due to the scarcity of data on timing and on the ultimate conversion of ordinary income to capital gain income, and in part due to the responsiveness of taxpayers’ capital gains realizations to influences other than tax rates. The Office of Tax Analysis incorporates all effects believed to be important and presents its best estimate of the expected effects.

Table 2 shows the separate revenue effects of the various elements of the capital gains proposal. In addition, it shows the "static" and behavioral effects incorporated in the estimate. Additional revenues resulting from positive macroeconomic effects of the proposal are not included in the revenue estimate. It is useful to describe the different effects incorporated in the revenue estimate before considering the targeting and growth-oriented features that distinguish the budget proposal. The revenue estimate is broken into seven different elements.

Effect of Tax Rate Reduction on the Level of Current Law Realizations. First, a tax loss results from reducing tax rates on capital gains that would be realized at current law tax rates; i.e., realizations that would have occurred regardless of a reduction in tax rates. This is what the "static" revenue estimate would be.

Effect of Increased Realizations. Second, lower tax rates will increase taxes due to additional realizations that would not otherwise occur in the current year. These "induced" gains are accelerated from realizations in future years, are due to portfolio shifting to capital gain assets from fully taxable income sources, or are taxable realizations that would otherwise have been tax-exempt because they would have been held until death, donated to charities, or realized but not reported.

The estimate is based on a responsiveness by taxpayers which results in additional revenue from induced gains more than sufficient to offset the revenue loss from lower rates on current gains. The responsiveness of capital gains realizations to changes in tax rates is one of the most important revenue estimating issues. The estimate of induced realizations is based on a survey of academic and government studies that examine taxpayers as a group over a number of years and other studies that examine individual tax returns over several years. With respect to the assumed degree of responsiveness of realizations to changes in the tax rate, the estimate takes a conservative position; there are studies that show both lower responses as well as higher ones. The response is greater in the initial years than in the long run due to the unlocking of gains accrued before the effective date.
The responsiveness of capital gains realizations to a general 45 percent exclusion from current law would be lower than that used to estimate the effect of the 1986 Act, where the top effective tax rate on capital gains increased from 20 percent to 33 percent. Most empirical studies have found that responsiveness decreases at lower marginal tax rates.

Effect of Deferring Gains Until After Effective Date. Third, the proposal will induce some taxpayers to defer realizations in the first half of 1989 until after the effective date of the proposal. With the announcement of the proposal in February and the assumed enactment and effective date of July 1, 1989, some realizations that otherwise would occur between the announcement date and the effective date will be delayed in order to benefit from the lower tax rate. The estimate predicts that revenue will be lost only over the fiscal year 1989-1990 period due to realizations deferred until the effective date.

Effect of Conversion of Ordinary Income to Capital Gain Income. Fourth, the proposal will induce taxpayers to realize additional capital gains currently and will encourage taxpayers to earn income in the form of lower taxed capital gains. Since the advent of preferential tax rates on capital gains in 1922, taxpayers have found various ways to convert ordinary taxable income into capital gains. Many of the most obvious conversion techniques have been stopped, but a capital gains tax rate differential will encourage taxpayers to shift to sources of income with lower tax rates.

Methods of converting ordinary income to capital gain income include shifting away from wages and salaries to deferred compensation, such as incentive stock options; shifting out of fully taxable assets, such as certificates of deposits, to assets yielding capital gains; shifting away from current yield assets to growth assets, including corporations reducing their dividend payout ratios; and investing in tax shelter activities. It is assumed that the conversion of ordinary income to capital gain income will occur gradually, increasing over the first 5 years.

The capital gains estimate for the 1986 Act included a large revenue gain from stopping the conversion of ordinary income to capital gain income by elimination of the differential. In fact, most of the revenue gain from reduced income shifting resulted from the drop in the top ordinary income tax rate from 50 percent to 28 percent. Before the 1986 Act, a 30 percentage point differential existed between the top ordinary tax rate and the top capital gains tax rate. Under the President's proposal, only a 13 percentage point differential will separate the 15 percent maximum rate on capital gains and the top 28 percent statutory marginal tax rate on ordinary income and only an 18 percentage point differential using the 33 percent effective marginal tax rate that applies to certain higher income taxpayers.
Effect of Excluding Depreciable Assets and Collectibles. The revenue estimate of the proposal is significantly affected by the exclusion of depreciable assets and collectibles from the lower rate. The 1985 Office of Tax Analysis study of capital gains found the responsiveness of capital gain realizations from assets other than corporate shares to be relatively low. That is, for some classes of assets the additional tax from induced realizations will not offset the tax loss from lower tax rates on gains that would occur under current law on such assets. By restricting the lower rates to more responsive assets, the proposal raises an incremental amount of additional net revenue.

Effect of Phasing In the 3-Year Holding Period Requirement. The 3-year holding period requirement is phased in gradually beginning in 1993. Any holding period encourages taxpayers to defer realizations until they are eligible for the lower rate. During the transition to the 3-year holding period, a one-time revenue loss will occur as realizations are deferred. After the transition is completed, the 3-year holding period raises revenue because it, like the depreciable asset exclusion, tends to limit the lower rate to assets more responsive to changes in capital gains tax rates. Assets sold after only 1 or 2 years for consumption or other purposes, rather than deferred to 3 years, would generally be less responsive to lower tax rates.

The phase-in of the 3-year holding period will encourage many taxpayers to defer realizations that would otherwise occur after 1 or 2 years until they become eligible for the lower tax rates. In addition, the phase-in will provide an incentive during the transition for some taxpayers to accelerate the realization of some gains. For instance, taxpayers who might realize gains held for 18 months in early 1993 might choose to accelerate those gains into calendar year 1992 to be eligible for the lower rate as 1-year assets. Thus, the phase-in will increase realizations in 1992 and revenues in fiscal years 1992 and 1993. Due to the two-step phase-in (the jump to 2 years in 1993 and to 3 years in 1995), the revenue pattern creates temporary incremental revenue losses in fiscal years 1994 and 1996.

Effect of 100 Percent Exclusion for Low-Income Taxpayers. The additional provision to exclude all qualified capital gain realizations from tax for taxpayers with low incomes will lose approximately $0.3 billion annually. In 1985, taxpayers with adjusted gross incomes of less than $20,000 accounted for 11.4 percent of net long-term capital gain realizations. Some of these taxpayers, however, were taxpayers with low adjusted gross income due to large tax preferences. The potential cost of this feature is reduced by limiting the zero tax rate to individuals who are not subject to the alternative minimum tax rate. The provision is considered after the initial 45 percent exclusion so the revenue loss is due only to the rate reduction from 8.25 percent (55 percent times 15 percent) to zero, not the full reduction from 15 percent to zero.
Total Effect of the Proposal. The President's proposal is estimated to increase Federal revenues in fiscal years 1989 through 1993 due to the large induced realizations in the initial years from the unlocking of previously accrued gains. During fiscal years 1994 through 1996, a one-time revenue loss will occur as the 3-year holding period requirement is phased in, causing taxpayers to defer short-term realizations. After fiscal year 1996, the proposal will increase Federal receipts between $1 and $2 billion annually.

These estimates do not include potential increases in the rate of macroeconomic growth expected from a lower capital gains tax rate. This conforms to the general budget practice of including macroeconomic effects of revenue and spending proposals in the underlying economic forecast and hence the budget revenue and outlay totals but excluding such estimates from budget lines showing revenue impacts of any particular proposal. In the case of the proposed lower capital gains tax rate, the investment, savings, and national income growth will be most significant over the longer term. Although not yet estimated, it is likely that positive revenues from macroeconomic improvements will be significant in the long run.
Table 1

Distribution of Net Long Term Capital Gains
For Returns With Long Term Capital Gains in 1985
(In Percent)

<table>
<thead>
<tr>
<th>Adjusted Gross Income Class</th>
<th>Distribution of Returns With Long Term Gains</th>
<th>Distribution of Long Term Gains</th>
<th>Percentage of Total Returns With Long Term Gains</th>
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<tbody>
<tr>
<td>Less than $10,000</td>
<td>14.6%</td>
<td>8.0%</td>
<td>4.4%</td>
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<tr>
<td>$10,000 to $19,999</td>
<td>15.6</td>
<td>3.4</td>
<td>6.2</td>
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<td>$200,000 or more</td>
<td>2.4</td>
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<td>80.7</td>
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<td>100.0%</td>
<td>100.0%</td>
<td>9.9%</td>
</tr>
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</table>

Department of the Treasury
Office of Tax Analysis

Source: 1985 IRS Statistics of Income

February 9, 1989
### Table 2

Revenue Effects of The President's Capital Gains Proposal  
Fiscal Years 1989–1999

<table>
<thead>
<tr>
<th>Effects of Proposal</th>
<th>Fiscal Years ($billions)</th>
<th>Longer Run*</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Budget Period</td>
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<tr>
<td>Effect of Tax Rate Reduction on Existing Gains</td>
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<tr>
<td>Projected For Current Law Realizations</td>
<td>-1.6</td>
<td>-11.9</td>
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<tr>
<td>Effect of Increased Realizations</td>
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<td>17.1</td>
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<tr>
<td>Effect of Delaying Gains Until the Effective Date</td>
<td>-0.2</td>
<td>-1.2</td>
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<tr>
<td>Effect of Conversion of Ordinary Income to Capital Gain Income</td>
<td>0.0</td>
<td>-0.1</td>
</tr>
<tr>
<td>Effect of Excluding Depreciable Assets and Collectibles</td>
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<td>1.2</td>
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<tr>
<td>Effect of Phased in Three Year Holding Period</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Effect of 100% Exclusion for Certain Low Income Taxpayers</td>
<td>-0.0</td>
<td>-0.3</td>
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<tr>
<td><strong>TOTAL REVENUE EFFECT OF PROPOSAL</strong></td>
<td>0.7</td>
<td>4.8</td>
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</table>

Department of the Treasury  
Office of Tax Analysis  
February 9, 1989

**Notes:**  
*These estimates include changes in taxpayer behavior but do not include potential increases in the level of macroeconomic growth.*  
*Details may not add due to rounding.*  
*Disaggregated effects are stacked in sequence.*  
*Longer run estimates assume 1994 growth extends past the budget forecast period.*
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 the base amount. The base amount is the taxpayer's average annual amount of qualified research and experimentation (R&E) expenditures over the prior three years (or if the taxpayer has not been in existence for three years, the average of the expenditures for its years in existence). This base, however, is subject to the limitation that it can never be less than 50 percent of current qualified expenditures.

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. With one exception, relating to certain research joint ventures, the "trade or business test" for purposes of the credit is the same as for purposes of the business deduction provisions of section 162. As a result, new corporations and corporations entering a new line of business cannot claim the credit for qualified R&E expenses until the expenses relate to an ongoing trade or business.

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 fifteen.

The amount of any deduction for research expenses is reduced by 50 percent of the amount of the tax credit taken for that year.

The research credit (including the University Basic Research Credit) expires on December 31, 1989.

Reasons for Change

The tax credit for research is intended to create 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 are not 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 it is available 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 whether the credit will be available. Thus, if the credit is to have the intended incentive effect, the R&E credit should be made permanent.

It is now widely acknowledged that the present incremental credit with a base equal to a moving average of previous expenditures amounts to an effective rate of credit which is much lower than the 20 percent statutory rate. (A credit's effective rate is the effective reduction in price for an additional expenditure undertaken by a firm and is a measure of the credit's incentive effect.) The credit's low effective rate is primarily attributable to the moving base, since additional R&E in one year increases the base and thereby decreases the credit in subsequent years. Thus, R&E generating one dollar of credit in the first
year will cause a 33.3 cent reduction in credit in each of the following three years, so that the credit's only benefit to a firm is a deferral rather than a reduction in taxes.

In some situations the moving base can actually turn the effective rate of credit negative, so that the credit encourages a firm to reduce R&E expenditures. This occurs both when a firm is growing slowly and current R&E expenditures are below the base and when a firm is growing quickly and is subject to the 50 percent base limitation. For firms with R&E expenditures below the base, negative effective rates of credit result because increases in R&E expenditures yield no current credit but reduce credits in future years. For firms subject to the base limitation, negative effective rates of credit result because each 50 cents of credit earned in the current year is followed by 33.3 cents less credit in each of the following three years.

Under the current credit structure, the availability of the credit, the amount of credit, and the revenue loss from the credit are positively related to the rate of inflation. High rates of R&E growth in the early 1980s (due both to real growth and to inflation) minimized the problem of the limited availability of the current credit to firms performing R&E, because inflation kept many slow-growing firms from falling below the base. A slowdown in R&E growth in the late 1980s, however, has made it increasingly apparent that an increase in the availability of the credit would improve its effectiveness.

Under current law, a new firm or a firm entering a new line of business may not earn credits until qualified expenses are incurred "in carrying on" a trade or business. Since it may be several years between initial research expenditures and the sale of products resulting from such expenditures, the tax system puts start-up firms at a competitive disadvantage vis-a-vis established firms who are already "carrying on" a trade or business.

Under present law, alternative sources of Federal government support for research receive different tax treatment. A tax credit is economically equivalent to a grant (but administered through the tax system). However, a firm's research costs funded through grants are not deductible while 50 percent of research costs offset by credits are deductible. Grants and tax credits should receive similar tax treatment.

Description of Proposal

The proposed R&E credit would retain the incremental feature of the present credit and its 20 percent rate, but would make the credit permanent and modify calculation of the base amount. The new base would be a fixed historical base equal to the average of
the firm's qualified R&E expenditures for the years 1983 through 1987, and would be indexed annually by the average increase in gross national product (GNP). Firms also would have the option of a separate seven percent credit for expenditures which exceed 75 percent of the base amount. In addition, for the first year the base would receive a one-time upward adjustment of two percent. As with current law, all firms would be subject to a 50 percent base limitation.

Under the proposal, the "trade or business" test would be made less stringent so that new firms and firms entering new lines of business could claim the credit without regard to the trade or business test if the taxpayer intended to use the results of the research in the active conduct of a present or future trade or business. The credit would not be available, however, for research undertaken for investment rather than business purposes. Thus, research intended solely to be licensed to unrelated parties for use in their businesses would not be eligible for the credit. In addition, the liberalized trade or business rules would apply only to in-house research and not to research contracted out to unrelated parties.

Finally, a taxpayer's section 174 research deductions would be reduced by the total amount of credit taken.

The proposal would apply to expenditures for research and experimentation on or after January 1, 1990.

Effects of Proposal

The proposed credit has the following advantages: (1) it makes the credit permanent; (2) it increases the incentive of the R&E credit; (3) it increases the percentage of R&E-performing firms that are eligible for the credit; (4) it eliminates the relationship between the availability of the credit and the rate of inflation; (5) it extends to new firms R&E incentives which had previously been available only to established firms; and (6) it rationalizes the tax treatment of alternative funding sources for research.

Stable tax laws that encourage research allow taxpayers to undertake research with greater assurance of tax consequences. A permanent R&E credit (including the University Basic Research Credit) permits taxpayers to establish and expand research facilities without the fear that tax rules will suddenly change.

The proposal would increase the credit's incentive effect by replacing the current credit's moving-base with a fixed-base structure. The critical feature of this "fixed" base is that a firm's current spending will have no effect on future credits. Thus, unlike the current credit, a dollar of credit earned in the current year does not reduce credits in the following year.
The proposal would also significantly increase the percentage of R&E-performing firms eligible for the credit. This increase is achieved through the design of the primary and alternative bases, which results in a larger number of firms with R&E expenditures above the base. Since the credit base is indexed to GNP, the amount of the credit allowable to any firm and the cost of the credit to the government no longer depends on the rate of inflation. In this way, the credit is provided only for real increases in R&E spending.

The proposal greatly expands the number of firms eligible for the credit by allowing new firms and firms beginning a new line of business to claim the credit for qualified R&E expenses that relate to the active conduct of a present or future trade or business. The proposal would allow expenditures of new firms and firms entering new lines of business to claim the credit without regard to the trade or business test if the taxpayer intends to use the results of the research in the active conduct of a present or future trade or business. Thus, a firm that intends merely to lease or license the results of research would continue to be ineligible for the credit.

Finally, the proposal disallows a deduction for R&E expenses to the extent of R&E credits taken. Disallowing a deduction for R&E expenses to the extent of R&E credits would provide similar tax treatment for all sources of Federal support for R&E. For example, assume Firm A conducts $100 in qualifying research and receives $20 from the government as a 20 percent matching grant. Under current law, Firm A is entitled to deduct only the $80 R&E expenses it actually incurred. By contrast, Firm B conducts $100 of research and receives $20 of tax credit rather than a $20 grant. Under current law, Firm B is entitled to deduct $90 of R&E expense ($100 expenditure minus 50 percent of the R&E credit) even though the $20 tax credit to Firm B is equivalent to $20 grant received by Firm A. Under the proposal, Firm B would be allowed to deduct $80, the same amount as firm A.

### Revenue Estimate

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<th>Fiscal Years ($ Billions)</th>
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<td>-0.4</td>
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Office of Tax Policy

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**R&E EXPENSE ALLOCATION RULES**

**Current Law**

Research and experimentation (R&E) allocation rules generally expired on May 1, 1988. Under those rules, U.S. firms were allowed to deduct 64 percent of their expenses for R&E performed in the United States from their U.S. income. (The technical terminology is that 64 percent of the expenses were allocated to U.S. source income.) The remaining 36 percent of expenses were allocated between U.S. and foreign source income on the basis of either gross sales or gross income. (The amount allocated to foreign source income on the basis of gross income had to be at least 30 percent of the amount allocated to foreign source income on the basis of gross sales.)

Since expiration of the R&E allocation rules, R&E expenses have been allocated between U.S. and foreign source income under detailed 1977 Treasury regulations, which were designed to match R&E expenses with the foreign and domestic source income related to the expenses.

**Reasons for Change**

The current allocation regulations do not provide sufficient incentives for U.S.-based research activity. In fact, a return to the 1977 Treasury regulations might actually reduce R&E expenditures in the United States from their current levels and might shift some research from the United States to overseas. To encourage U.S.-based R&E, more favorable allocation rules are needed.

The Tax Reform Act of 1986 increased the significance of the allocation rules for many taxpayers by expanding the number of U.S. firms that have excess foreign tax credits and by increasing the size of such excess credits. Firms derive greater tax benefits by using these credits to offset their current U.S. tax liability rather than carrying them forward or deducting them. Firms can use more of their foreign tax credits to offset their U.S. tax liability to the extent that R&E expenses are allocated to U.S. source income rather than to foreign source income. The proposal would allow more R&E expenses to be allocated to U.S. source income.

The new rules should be made permanent because after more than 10 years of instability, taxpayers need certainty. Temporary rules for allocating R&E expenses were passed in 1981, 1984, 1985, 1986, and 1988. U.S. firms need permanent rules so they can be certain of the long-term tax ramifications of their R&E expenses. Stable tax laws would encourage growth in U.S. research activity.
Description of Proposal

The proposal would permit 67 percent of R&E expenses to be allocated to U.S. source income. The remaining 33 percent would be allocated on the basis of either gross sales or gross income. No limitation would be placed on the allocation to U.S. source income under the gross income method.

The proposal would apply retroactively to the expiration of the earlier rules, generally May 1, 1988.

Effects of Proposal

The proposal would result in greater tax savings than current law for U.S. firms from their U.S.-based R&E expenses. Current law allocates more R&E expenses to foreign source income and less to U.S. source income than the proposal. The higher allocation to foreign source income under current law reduces the amount of foreign tax credits that firms can use to offset their U.S. tax liability. Because many firms have excess foreign tax credits, the existing allocation regulations can reduce firms' U.S.-based R&E expenditures.

The difference in the effects of the current regulations and the proposal is best illustrated by an example. Assume that before deductions a firm has $1,075 in U.S. source income and $1,075 in foreign source income. Assume also that the firm has $100 in R&E expenses and $500 in foreign tax credits. Assume under current law, $25 of expenses are allocated to U.S. source income and $75 to foreign source income. Thus, for U.S. tax purposes, the firm is considered to have $1,050 ($1,075 - $25) in U.S. source income and $1,000 ($1,075 - $75) in foreign source income. Assuming the firm pays tax at a 34-percent rate, the firm would have a U.S. tax liability of $697 [($1,050 + $1,000) * .34]. But the firm can offset $340 ($1,000 * .34) of its U.S. tax liability by using its foreign tax credits. Thus, the firm would have to pay U.S. tax of $357 ($697 - $340). The firm could carryover the remaining $160 ($500 - $340) in foreign tax credits.

Under the proposal, $75 of R&E expenses would be allocated to U.S. source income and $25 to foreign source income. (The example assumes that the amount of foreign tax paid is unaffected by changes in U.S. allocation rules.) Thus, for U.S. tax purposes, the firm would be considered to have $1,000 ($1,075 - $75) in U.S. source income and $1,050 ($1,075 - $25) in foreign source income. The firm would still have a U.S. tax liability of $697 [($1,050 + $1,000) * .34]. But the firm would now be able to offset $357 ($1,050 * .34) of its U.S. tax liability by using its foreign tax credits. Thus, the firm would only have to pay U.S. tax of $340 ($697 - $357). The firm would carryover the remaining $143 ($500 - $357) in foreign tax credits.
The net result is that the proposal would reduce the amount of U.S. tax that the firm must pay by $17.

Revenue Estimate

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<tbody>
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<td>-1.7*</td>
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<td>-0.8</td>
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*The FY 1990 revenue loss includes the retroactive application of this proposal.

Office of Tax Policy
ENERGY TAX INCENTIVES

Current Law

Summary. Current law provides incentives for domestic oil and gas exploration and production by allowing the expensing of intangible drilling costs ("IDCs") and the use of percentage depletion. These two incentives are subject to certain limitations and their benefits are included as preferences in the alternative minimum tax ("AMT"). Current law does not provide any further tax incentives for either exploratory drilling or tertiary enhanced recovery techniques.

Exploratory Drilling vs. Development Drilling. The search for new oil and gas reserves typically begins with certain preliminary tests (e.g., geological and geophysical tests) designed to determine the likelihood of discovering commercial quantities of hydrocarbons. If such tests suggest that oil and gas may be present, further tests may be conducted. New oil and gas reserves, however, are typically identified only by exploratory drilling (i.e., drilling in a property not previously drilled and not located next to another producing property). About 55 percent of exploratory well drilling expenditures result in dry holes. A dry hole results if commercially recoverable oil and gas is not found. A taxpayer is allowed to expense all costs of a dry hole upon abandonment of the dry hole. If exploratory drilling is successful in locating oil and gas in commercial quantities, additional drilling, termed development drilling, is done to recover the maximum amount of oil and gas. Current law does not provide any special incentive for exploratory drilling.

Tertiary Enhanced Recovery Techniques. Tertiary enhanced recovery techniques increase available reserves by producing oil and gas that cannot be recovered economically with conventional pumping or water flooding. Tertiary enhanced recovery projects use steam, CO2, or chemical injectants. Current law does not provide any special incentive for these projects.

Intangible Drilling Costs (IDCs). Current law generally requires the capitalization of expenditures for permanent improvements or betterments made to increase the value of any property. An exception to the capitalization requirement permits the expensing of IDCs paid in connection with the drilling of oil, gas, and geothermal wells. IDCs include amounts paid for labor, fuel, repairs, and site preparation. IDCs do not include geological and geophysical costs ("G&G costs") and surface casing costs (e.g., the cost of casings, valves, pipelines, and other facilities required to control, transport, or store the oil and gas). Costs that do not qualify as IDCs must be capitalized and recovered through depreciation or depletion.
Percentage Depletion. Cost recovery with respect to oil and gas properties is allowed by means of depletion deductions. The depletion deduction may be calculated under the cost depletion method or, with significant restrictions, under the generally more favorable percentage depletion method. Under cost depletion, the amount of the depletion deduction is equal to the portion of the taxpayer's basis equal to the percentage of total oil or gas reserves produced during the year. Cost depletion deductions may not exceed the taxpayer's basis in the property.

Under percentage depletion, the amount of the depletion deduction is equal to a statutory percentage of gross income from the property (15 percent in the case of oil and gas production). Percentage depletion deductions over the life of a property may exceed the cost of the property. Independent producers and royalty owners may use percentage depletion, but only with respect to 1,000 barrels of production per day. Percentage depletion with respect to oil and gas is not permitted for retailers or refiners of oil or gas products. Percentage depletion is also unavailable for oil and gas properties that have been transferred after they have been "proven" (i.e., shown to have oil or gas reserves). The percentage depletion deduction may not exceed either 50 percent of the taxpayer's net income from the property or 65 percent of the taxpayer's net taxable income for the year.

Alternative Minimum Tax (AMT). An alternative minimum tax is imposed on certain taxpayers. This tax is calculated with respect to alternative minimum taxable income ("AMTI"), which is calculated by making certain adjustments and adding tax preference items to regular taxable income. Both IDCs and percentage depletion deductions are preference items for both corporate and non-corporate taxpayers, and thus are included in AMTI.

The percentage depletion tax preference item is the amount by which the depletion deduction claimed for regular tax purposes exceeds the taxpayer's basis in the property at the end of the taxable year (disregarding the depletion deduction for the year). Treating such amounts as a preference item in computing AMTI may reduce or eliminate the benefit of permitting percentage depletion for certain taxpayers.

The IDC tax preference is the amount by which a taxpayer's "excess IDCs" claimed with respect to successful wells exceed 65 percent of his net income from oil, gas, or geothermal properties. The "excess IDCs" are the amount by which the IDC deductions claimed for the year exceed the deductions that would have been claimed had the IDCs been capitalized and either amortized over 120 months or recovered through cost depletion. Thus, for AMT purposes, the IDC deduction for incremental IDC expenditures in excess of the net income limit is reduced to zero.

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Reasons for Change

The sharp reduction in world oil prices and the increasing levels of oil imports may raise both energy security and national security concerns. Our increased dependence on foreign oil may leave the nation vulnerable to potential foreign supply disruptions. The Administration supports an energy policy that is designed to address these concerns by improving our long-term energy security and strengthening the domestic oil industry.

An increase in domestic oil and gas reserves would improve our energy security. The level of proven domestic reserves is closely related to the level of domestic exploratory drilling. The level of domestic exploratory drilling, however, has fallen by 70 percent from recent levels, largely due to uncertainty concerning low world oil prices. In addition, over the same time period, development drilling has increased 20 percent, resulting in a substantial decline in domestic oil and gas reserves. Special tax incentives are appropriate to encourage higher levels of exploratory drilling which may lead to increased domestic reserves.

Current law limits the incentive effects of IDC expensing and percentage depletion, particularly for independent producers, which have historically drilled a majority of our exploratory wells. Current rules for the use of percentage depletion by independent producers limit the use to properties acquired by or transferred to an independent producer before the property is shown to have oil or gas reserves (the "transfer rule"). The transfer rule discourages the transfer of producing wells that are uneconomic in the hands of current owners to owners that may be more efficient, more willing to bear current losses, or better able to use the tax benefits of current depletion. Repeal of the transfer rule would encourage the continued operation of such properties by small producers with lower overhead. By keeping marginal wells in production, U.S. oil production would be maintained without additional drilling costs. Current law also provides that percentage depletion may not exceed 50 percent of the net income of a property calculated before depletion. At current oil and gas prices, the 50 percent net income limitation may significantly reduce the benefits of percentage depletion for production from properties generating a small amount of net income. Raising the net income limitation to 100 percent would allow some oil producers to claim greater depletion deductions, thus encouraging them to operate marginal properties. Moreover, raising the limit might also encourage added investment in exploratory drilling projects. In addition, the current alternative minimum tax (AMT) severely limits the incentive effects of IDC expensing, particularly for independent producers.

The level of exploratory drilling and domestic reserves would be increased by providing a program of temporary IDC credits, less restrictive rules for the use of percentage depletion, and AMT relief, all targeted to exploratory drilling in general and
to independent producers in particular. A temporary tax credit for new tertiary enhanced recovery projects would encourage the recovery of known energy deposits that are currently too costly to produce.

Description of Proposal

Four incentives are proposed to encourage exploration for new oil and gas fields and the reclamation of old fields. Two proposals would provide temporary tax credits. The temporary tax credits would be phased out if the average daily U.S. wellhead price of oil is at or above $21 per barrel for a calendar year.

First, a temporary 10 percent tax credit would be allowed for the first $10 million of expenditures (per year per company) on exploratory intangible drilling costs and a 5 percent credit would be allowed for the balance effective January 1, 1990. Second, a temporary 10 percent tax credit, effective January 1, 1990, will be allowed for all capital expenditures on new tertiary enhanced recovery projects (i.e., projects that represent the initial application of tertiary enhanced recovery to a property).

These tax credits could be applied against both the regular tax and the alternative minimum tax. However, the credits, in conjunction with all other credits and net operating loss carryforwards, could not eliminate more than 80 percent of the tentative minimum tax in any year. Unused credits could be carried forward.

Third, the proposal would eliminate the "transfer rule," which discourages the transfer of proven properties to independent producers and royalty owners, and would increase the percentage depletion deduction limit for independent producers to 100 percent of the net income of each property. These changes would increase the availability to independent producers of the percentage depletion tax incentive. The proposed effective date of each change would be January 1, 1990.

Fourth, the proposal would eliminate 80 percent of current AMT preference items generated by exploratory IDCs incurred by independent producers effective January 1, 1990. This would allow independent producers to deduct 80 percent (rather than zero, as under current law) of exploratory excess IDCs in excess of the net income limit for purposes of the AMT. As under current law, the net income limit would be equal to 65 percent of oil and gas net income determined without regard to excess IDC deductions.
Effects of Proposal

The proposed new incentive program for the oil and gas industry would encourage exploration for new oil and gas fields and the reclamation of old fields. The incentives would strengthen the financial health of the smaller independent producers in particular. The incentives would help the nation achieve greater energy independence and greater national security.

Revenue Estimate

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<tbody>
<tr>
<td>10 percent credit for exploratory drilling</td>
<td>-0.2</td>
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<tr>
<td>10 percent credit for tertiary enhanced recovery</td>
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<tr>
<td>Eliminate the transfer rule and increase the net income allowance to 100 percent for percentage depletion by independent producers and royalty owners</td>
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<td>Eliminate 80 percent of exploratory IDC tax preferences from minimum tax for independent producers</td>
<td>-0.1</td>
<td>-0.1</td>
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*$50 million or less.

Office of Tax Policy
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 economically distressed areas, they are not limited to use with respect to such areas.

Among the existing general tax incentives that aid economically distressed areas is the targeted jobs tax credit. This credit, which provides an incentive to employers to hire economically disadvantaged workers, often is available to firms locating in economically distressed areas. An investment credit also is allowed for certain investment in low-income housing or the rehabilitation of certain structures. Another type of tax incentive permits the deferral of capital gains taxation upon certain transfers of low-income housing and certain exchanges of business or investment property for property of the same kind. As a final example of a general tax incentive benefitting economically distressed areas, state and local governments are permitted to issue a limited number of tax-exempt private activity bonds that provide low-cost financing for businesses to begin or expand their ventures.

Reasons for Change

Despite sustained national prosperity and growth, certain areas have not kept pace. To help these areas share in the benefits of continued economic growth, this Administration proposes enterprise zones to stimulate local government and private sector revitalization of economically distressed areas.

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 expanding in severely depressed areas. Enterprise zones would let business and innovation bloom in places where there has been little hope and little opportunity.

A new era of public/private partnerships is needed to help distressed cities and rural areas help themselves. The enterprise zone initiative will help determine the effectiveness of selected Federal tax incentives and reduced Federal regulations in stimulating the private and local public investment needed to revitalize economically deprived areas.
Description of Proposal

The proposed enterprise zone initiative would include selected Federal employment and investment tax credits. These tax credits will be offered in conjunction with Federal, state, and local regulatory relief. Up to 70 zones will be selected between 1990 and 1993.

There would be both capital-based and employment-based tax credits, although the details of the tax credits have not been specified. The extent of the tax subsidies will vary, with larger subsidies in the early years that decline over time. Total Federal revenue losses will gradually rise, however, as more zones are designated.

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.

Revenue Estimate

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Office of Tax Policy
CURRENT LAW

The Internal Revenue Code provides assistance to low-income working parents through both the earned income tax credit (EITC) and the child and dependent care tax credit.

**Earned Income Tax Credit.** Low-income workers with minor dependents may be eligible for a refundable income tax credit of up to 14 percent of the first $6,500 in earned income. The maximum amount of the EITC is $910. The credit is reduced by an amount equal to 10 percent of the excess of adjusted gross income (AGI) or earned income (whichever is greater) over $10,240. The credit is not available to taxpayers with AGI over $19,340. Both the maximum amount of earnings on which the credit may be taken and the income level at which the phase-out region begins are adjusted for inflation (1989 levels are shown).

Earned income eligible for the credit includes wages, salaries, tips and other employee compensation, plus the amount of the taxpayer's net earnings from self-employment. Eligible individuals may receive the benefit of the credit in their paychecks throughout the year by electing advance payments.

**Child and Dependent Care Credit.** Taxpayers may also be eligible for a nonrefundable income tax credit if they incur expenses for the care of a qualifying individual in order to work. A qualifying individual is (1) a dependent who is under the age of 13 for whom the taxpayer can claim a dependency exemption; (2) the spouse of the taxpayer if the spouse is physically or mentally incapable of caring for himself or herself; or (3) a dependent of the taxpayer who is physically or mentally incapacitated and for whom the taxpayer can claim a dependency exemption or could claim as a dependent except that he or she has more than $1,500 in income.

To claim the child and dependent care credit, taxpayers must be married and filing a joint return or be a head of household. Two-parent households, with only one earner, do not qualify for the credit unless the non-working spouse is disabled or a full-time student.

The amount of employment-related expenses that is eligible for the credit is subject to both a dollar limit and an earned income limit. Employment-related expenses are limited to $2,400 for one qualifying individual and $4,800 for two or more qualifying individuals. Further, employment-related expenses cannot exceed the earned income of the taxpayer, if single, or for married couples, the earned income of the spouse with the lower earnings.
Taxpayers with AGI of $10,000 or less are allowed a credit equal to 30 percent of eligible employment-related expenses. For taxpayers with AGI of $10,000 to $28,000, the credit is reduced by one percentage point for each $2,000, or fraction thereof, above $10,000. The credit is limited to 20 percent of employment-related dependent care expenses for taxpayers with AGI above $28,000.

Reasons for Change

Current law does not adequately provide for the child care needs of low-income working families. Many low-income families do not incur a federal income tax liability and as a consequence are unable to claim the child and dependent care credit. Further, many low-income families rely on relatives and neighbors to provide care for their children, and thus these families cannot claim the child and dependent care credit. The EITC, while refundable, does not adjust for differences among working families in the costs of providing care according to the age of the dependent child. Pre-school children generally require more extensive care than older children who may be in a school setting for much of the day.

Description of Proposal

Proposed Child Tax Credit. Low-income families, containing at least one worker, would be entitled to take a new tax credit of up to $1,000 for each dependent child under age four. For each child under the age of four, families could receive a credit equal to 14 percent of earned income, with a maximum credit equal to $1,000 per child. Initially, the credit would be reduced by an amount equal to 20 percent of the excess of AGI or earned income (whichever is greater) over $8,000. As a consequence, the credit would not be available to families with AGI or earned income greater than $13,000. In subsequent years, both the starting and end-points of the phase-out range would be increased by $1,000 increments. In 1994, credit would phase-out between $15,000 and $20,000.

The credit would be refundable and would be effective for tax years beginning January 1, 1990. Families would have the option of receiving the refund in advance through a payment added to their paycheck.

Refundable Child and Dependent Care Credit. The existing child and dependent care tax credit would be made refundable. Families could not claim both the new child credit and the child and dependent care credit with respect to the same child but could choose the larger of the two credits. The refundable child and dependent care credit would be effective for tax years beginning January 1, 1990.
Effects of the Proposal

The proposal would increase the resources available to low-income families, better enabling them to choose the child-care arrangements which best suit their needs and correspond to their personal values. About 2.5 million working families with children under the age of four will initially be eligible for the new child tax credit. When the proposal is fully implemented, eligibility will be expanded to approximately 1 million additional families. These families will also have the option of claiming the refundable child and dependent care credit, although they will not be able to claim both credits with respect to the same child. In addition, low-income parents of children between the ages of four and twelve would benefit from the refundability of the child and dependent care credit if they incur child-care expenses in order to work.

Consider, for example, a single working mother of two children, ages three and six years old. The mother earns $10,000 a year and has no other sources of taxable income. She pays a neighbor $20 a week to care for her younger child. Her older child is enrolled in a latchkey program during the school year and a neighborhood park program during the summer at a total cost of $500 per year. In total, she spends $1,540 a year for child care in order to work. Under current law, she is not entitled to claim the child and dependent care credit. At a 30 percent credit rate on dependent care expenses, the credit would be $462. However, she has no tax liability as a consequence of the standard deduction and personal exemptions, and therefore cannot claim the credit.

Under the proposal, the mother would be able to claim the proposed child tax credit. In 1990, she would be entitled to a credit equal to $600. (A mother in similar circumstances in 1992 would be entitled to the full $1,000 credit.) In addition, the mother would be able to claim the child and dependent care tax credit of $150 based on the expenses associated with the day care of her older child. In total, she would be entitled to a refund of $750.

Revenue Estimate

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* $50 million or less.

1 Increased outlays attributable to refunds payable to eligible individuals with no tax liability.
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 (AFDC), Title IV-E Foster Care, or Supplemental Security Income (SSI). 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 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 and reimbursed would be included in income in the year in which the reimbursement occurred.

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 which 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

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<th>Fiscal Years ($ millions)</th>
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* less than $500,000

Office of Tax Policy
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). 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. A quarter of state and local government employees are not covered by voluntary agreements nor by law. However, eighty-five 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 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 fully contributing.

Description of Proposal

As of October 1, 1989, all state and local government employees would be covered by Medicare Hospital Insurance.

Effects of Proposal

An additional 2 million state and local government employees would be contributing 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

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1Net of income tax offset.

Office of Tax Policy
REPEAL OF THE AIRPORT AND AIRWAY TRUST FUND TAX TRIGGER

Current Law

The Airport and Airway Safety and Capacity Expansion Act of 1987 established a trigger that would reduce by 50 percent several of the airport and airway trust fund taxes. The trigger would take effect in calendar year 1990 if the 1988 and 1989 appropriations for the capital programs funded by these taxes were less than 85 percent of authorizations. The trigger would reduce by 50 percent the 8 percent air passenger tax, the 5 percent air freight tax, and the 14 cents per gallon noncommercial aviation fuels tax. It would also substantially reduce the aviation gasoline tax.

Reasons for Change

Given congressional action for 1988 and 1989, the trigger would take effect and reduce by 50 percent these airport and airway trust fund taxes. The receipts from these taxes are required to modernize airport and airway facilities in the United States in the early 1990s.

Description of Proposal

The proposal would repeal the tax reduction trigger, resulting in increased airport and airway trust fund receipts of $1.2 billion in 1990 and increased governmental receipts (net of income and employment tax offsets) of $0.9 billion.

Effects of Proposal

Repealing the trigger is required for the accumulation of funds for the modernization of airport and airway facilities in the United States in the early 1990s.

Revenue Estimate

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¹Net of income tax offsets. The estimates shown are relative to current services receipts which assume continuation of trigger rates through 1994.

Office of Tax Policy
EXTENSION OF THE COMMUNICATIONS (TELEPHONE) EXCISE TAX

Current Law

The Omnibus Budget Reconciliation Act of 1987 extended the communications excise tax until the end of 1990. The tax is imposed at a rate of three percent on local and toll (long-distance) telephone service and on teletypewriter exchange service.

Reasons for Change

The communications excise tax was originally enacted in 1914 and has been imposed continuously since 1932, even though it has been scheduled to expire continuously since 1959. Allowing the tax to expire would reduce Federal tax receipts by approximately $2.5 billion annually.

Description of Proposal

The proposal would permanently extend the three percent Federal communications excise tax. The tax rate is substantially less than the ten percent rate that was in effect between 1954 and 1972, and as low or lower than the rate in effect for any year since 1932 (except for 1980–82). The base of the tax would not be broadened.

Effects of Proposal

Extension of the communications excise tax would maintain a revenue source that has been in existence continuously since 1932, and would avoid the disruption that would occur if the tax were allowed to expire and then were reenacted.

Revenue Estimate¹

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</table>

¹Net of income tax offset.

Office of Tax Policy
MISCELLANEOUS PROPOSALS AFFECTING RECEIPTS

Current Law

Internal Revenue Service (IRS) Enforcement Initiative. IRS currently allocates some of its funding for tax law enforcement.

Increase Nuclear Regulatory Commission (NRC) User Fees. The proportion of the NRC's costs incurred in regulating nuclear power plants will decline from 45 percent in 1989 to 33 percent in 1990.

Initiate Federal Emergency Management Agency (FEMA) User Fees. The costs that FEMA incurs as NRC's agent in regulating the evacuation plans of nuclear power plants are financed through general revenues.

Increase District of Columbia (D.C.) Employer Contributions to the Civil Service Retirement System (CSRS). The D.C. government contributes 7 percent of wages and salaries to CSRS and D.C. employees contribute an additional 7 percent.

Initiate Federal Marine Fishing Licenses and Fees. The costs of Federal efforts to conserve and manage the Nation's marine fishery resources are financed through general revenues.

Extend Reimbursable Status to Amtrak. The Technical and Miscellaneous Revenue Act of 1988 exempts public commuter railroads from paying the full railroad unemployment tax rate in 1989 and 1990 and permits them to reimburse the unemployment fund for the actual costs of their employees. The exemption does not extend to Amtrak.

Eliminate Superfund Petroleum Tax Differentials. The superfund petroleum tax is 8.2 cents per barrel for domestic crude oil and 11.7 cents per barrel for imported products.

Other Proposals. Pay raise proposals; extending customs processing fee; establish a fee for U.S. Travel and Tourism Administration; user fee on taxpayer telephone information services.

Reasons for Change

Internal Revenue Service (IRS) Enforcement Initiative. The gap between taxes owed and taxes voluntarily paid contributes to the Federal deficit and undermines the system of voluntary compliance.
Increase NRC User Fees. Costs of regulating the nuclear power industry should be fully borne by the users of the services.

Initiate FEMA User Fees. Costs of regulating the evacuation plans of the nuclear power industry should be borne by the users of the services, as are the general regulatory costs.

Increase D.C. Employer Contributions to CSRS. Retirement costs exceed the current combined contributions of the employer and employee. The excess costs should be financed by the D.C. government.

Initiate Federal Marine Fishing Licenses and Fees. The costs of Federal conservation and management of marine fishery resources should be paid by the commercial fishermen who directly benefit from the services.

Extend Reimbursable Status to Amtrak. The reimbursement arrangement ensures that commuter railroads use the public subsidies they receive to hold down fares rather than paying for the high unemployment costs of private freight railroads. Amtrak is in much the same position as the commuter railroads.

Eliminate Superfund Petroleum Tax Differentials. The current tax differential could subject the United States to retaliation or possible compensatory damage payments under the General Agreement on Tariffs and Trade (GATT).

Description of Proposal

IRS Enforcement Initiative. Increase IRS funding for tax law enforcement.

Increase NRC User Fees. Increase fees to cover 100 percent of NRC's regulatory costs, effective October 1, 1989.

Initiate FEMA User Fees. Recover 100 percent of regulatory costs through user fees, effective October 1, 1989.

Increase D.C. Employer Contributions to CSRS. The D.C. government will pay retirement cost-of-living adjustments (COLAs) to its retirees and their survivors. The initial annual payment would begin in 1991 because of a proposed budget COLA freeze for government annuitants in 1990.

Initiate Federal Marine Fishing Licenses and Fees. Establish a permit and an ad valorem fee on commercial sales, effective January 1, 1990. Applicable only to fishermen who fish in the fishery conservation zone (3 to 200 miles offshore) or who fish for federally managed species.
Extend Reimbursable Status to Amtrak. Require Amtrak to reimburse the unemployment fund for actual costs of their employees rather than paying the full railroad industry unemployment tax.

Eliminate Superfund Petroleum Tax Differentials. Equalize the excise taxes through a slight increase in the tax rate on domestic crude oil and a slight decrease in the rate on imported petroleum products.

Other Proposals. Additional changes affecting receipts include the Administration's pay raise proposals; extension of the customs processing fee, which is scheduled to expire September 30, 1990, at current rates; and the establishment of a fee for the U.S. Travel and Tourism Administration (USTTA). A user fee on taxpayer telephone information services is proposed for 1991; a design evaluation will be conducted in 1989 and 1990 that will include an actual demonstration of the technologies and systems capabilities.

Effects of Proposal

IRS Enforcement Initiative. Ensure that taxpayers correctly report their income for tax purposes and improve collection of past due taxes.

Increase NRC User Fees. Users of NRC regulatory services pay the full costs of regulation.

Initiate FEMA User Fees. Users of FEMA regulatory services pay the full costs of regulation.

Increase D.C. Employer Contributions to CSRS. Requires the D.C. government to bear more of the retirement costs of its employees.

Initiate Federal Marine Fishing Licenses and Fees. Requires users of federal fishery research, conservation, and management services to pay the costs of the services.

Extend Reimbursable Status to Amtrak. Helps to reduce the Amtrak operating deficiency and prevents public funds intended to subsidize public commuter railroad fares from unintentionally cross-subsidizing high unemployment freight railroads.

Eliminate Superfund Petroleum Tax Differentials. Achieves a system of excise taxes on petroleum that is consistent with GATT.
### Revenue Estimates

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* $50 million or less.

Office of Tax Policy
REVENUE EFFECTS OF PROPOSED LEGISLATION
## REVENUE EFFECTS OF PROPOSED LEGISLATION

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* = less than $50 million

1/ Refundable tax credits involving refunds which exceed tax liability are shown as increased outlays. Outlays will increase by $0.2 billion in FY90, $1.8 billion in FY91, $2.2 billion in FY92, $2.4 billion in FY93, and $2.8 billion in FY94.